Supreme Court, U. S.
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MICHAEL RODAK, JR., CLERK

APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC., *Petitioner,*

v.

UNITED STATES OF AMERICA, et al.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 29, 1973
CERTIORARI GRANTED JANUARY 21, 1974

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United States Court of Appeals

FOR THE SECOND CIRCUIT

IN the Matter

of

FREEDOMLAND, INC.,

Bankrupt,

WILLIAM OTTE,

Trustee-Appellant,

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

Appellants.

Filings—Proceedings

72—Filed copies of docket entries and notice of appeal (Ottee)

72—Filed copies of docket entries and notice of appeal (USA)

72—Filed copies of docket entries and notice of appeal (City of N.Y.)

72—Filed record (original papers of district court) (& in 72-1551)

72—Filed supplemental record (original papers of district court) (& in 72-1551) (& in 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 8-15-72 (Otte) (& in 72-1551, 72-1716)

72—Filed notice of appearance (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 9-30-72 (Otte) (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant's brief and appendix to 10-30-72 (Otte) (& in 72-1551, 72-1716)

Relevant Docket Entries of Circuit Court of Appeals

Filings—Proceedings

72—Filed brief and appendix, appellant with proof of service (Otte) (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant (City of N.Y.) brief to 1-3-73 (& in 72-1551, 72-1716)

72—Filed order extending time to file appellant (U.S.A.) brief to 1-3-73 (& in 72-1551, 72-1716)

72—Filed order extending time to file appellants (U.S.A. and City of N.Y.) briefs to 1-30-73

73—Filed order extending time to file appellants (U.S.A. and City of N.Y.) briefs to 2-28-73 (& in 72-1551, 72-1716)

73—Filed brief, appellee (USA) (W/Pofs) (& in 72-1551, 72-1716)

73—Filed brief, appellee (City of N.Y.) (W/Pofs) (& in 72-1551, 72-1716)

73—Argument heard (by: Hays, Mulligan, Oakes) (& in 72-1551, 72-1716)

73—Judgment Affirmed in Part, reversed and remanded in part, Oakes, CJ (& in 72-1551, 72-1716)

73—Filed judgment (& in 72-1551, 72-1716)

73—Issued Mandate (opinion & judgment) (& in 72-1551, 72-1716)

73—Filed notice of filing of petition for writ of certiorari (S. C. #73-375) (& in 72-1551, 72-1716)

9-19-73—Original and supplemental record returned to district court

10- 4-73—Filed receipt of return of original & supplemental record to District Court

1-28-74—Filed certified copy of order of Supreme Court granting petition for writ of certiorari (& in 72-1551, 72-1716)

Order of Circuit Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the eighth day of June, one thousand nine hundred and seventy-three.

Present: HON. PAUL R. HAYS
HON. WILLIAM H. MULLIGAN
HON. JAMES L. OAKES
Circuit Judges,

72-1551

72-1716

72-1546

In the Matter

of

FREEDOMLAND, INC.,

Bankrupt,

WILLIAM OTTE,

Trustee-Appellant,

UNITED STATES OF AMERICA and THE CITY OF NEW YORK,

Appellants.

Appeal from the United States District Court for the Southern District of New York.

Order of Circuit Court of Appeals

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court, with costs to be taxed against the appellant William Otte.

A. DANIEL FUSARO,
Clerk
by: VINCENT A. CARLIN
Chief Deputy Clerk

Decision of Circuit Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 427, 804, 805—September Term, 1972.

(Argued March 15, 1973 Decided June 8, 1973.)

Docket Nos. 72-1546, 72-1551, 72-1716

In re Freedomland, Inc.

Bankrupt.

Before:

HAYS, MULLIGAN and OAKES,

Circuit Judges.

Appeal from a judgment in the Southern District of New York, Constance B. Motley, *Judge,* (1) ordering the bankruptcy trustee to withhold taxes and file necessary forms on wages earned but not paid prior to bankruptcy; (2) assigning the taxes a fourth priority as "taxes due and owing by the bankrupt," 11 U.S.C. § 104(a)(4); and (3) denying New York City's claim for withheld taxes on the ground that the City's income tax was passed after the date the wages were earned.

Affirmed in part, reversed and remanded in part.

HOWARD KARASIK, New York, New York *for Appellant Otte, Trustee in Bankruptcy of Freedomland, Inc.*

SUSAN FREIMAN, Assistant United States Attorney (Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, on the brief) *for Appellant United States.*

SAMUEL J. WARMS, New York, New York (Norman Redlich, Corporation Counsel for the City of New York, Raymond Herzog and Cornelius F. Roche, of counsel), *for Appellant New York City.*

OAKES, *Circuit Judge*:

This case presents the esoteric, but nevertheless highly practical, issue of how withholding on wages earned before bankruptcy is to be handled in bankruptcy. Involved are both the income tax laws, silent in this regard as to the effect of bankruptcy, and the bankruptcy laws, silent as to the status of moneys withheld and indeed inarticulate as to the category of priority within which *previously* earned wages fit. The problems presented in winding a tortuous path between two inexact sets of statutes in these two different areas of law as to withholdings claimed due the United States are further complicated by virtue of a claim for income tax withholdings by the City of New York on a statute enacted *after* the wages were earned but before any payments on their account to the wage earners have been made by the bankruptcy trustee.

Freedomland, Inc., filed an arrangement petition under Chapter XI of the Bankruptcy Act on September 15, 1964, and was adjudicated a bankrupt on August 30, 1965. During the statutory period for filing claims, 413 claims of $600 or less, totaling approximately $80,000, were filed by former employees of Freedomland on account of wages earn[illegible] *before* the filing of the Chapter XI petition. 11

U.S.C. § 93. No claims for withholding, social security or related taxes were filed either by the United States or the City of New York during the statutory filing period or otherwise.[1] The trustee, on November 7, 1969, moved the referee for an order authorizing payment to the wage claimants without withholding income, social security or other taxes and an order specifically declaring that he was not required (1) to make any such payments to any governmental body; (2) to prepare, distribute or file wage and tax statements for the employees or as an employer; or (3) to pay any penalties. The referee, Edward J. Ryan, was apparently much taken with the criticism by a fellow referee of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), which held that a trustee must withhold income and social security taxes and that the taxes were payable as an administration expense entitled to first priority.[2] Referee Ryan accordingly on January 27, 1971, granted the trustee's petition on all counts, holding that "compliance with withholding and reporting requirements of tax authorities

[1] The United States had filed a claim for federal income and social security taxes due on wages *actually paid* during the quarter immediately preceding the petition for an arrangement. No claim was filed for those due on *unpaid* wages during that quarter, however, and it is withholdings on those wages which are in dispute here.

[2] *See* Hiller, *The Folly of the Fogarty Case,* 32 J. of Nat'l Ass'n of Ref. 54 (1958).

In general terms § 64(a) of the Bankruptcy Act, 11 U.S.C. § 104, categorizes debts having priority in the following order:

1. costs and expenses of administration;
2. wages not exceeding $600 earned within three months before the date of commencement of the proceeding;
3. creditor's expenses in setting aside confirmation of an arrangement or obtaining refusal of a discharge;
4. "taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof . . . ." and
5. debts owing to persons entitled to property by law.

is utterly inconsistent with the spirit and the letter of the Bankruptcy Act," particularly the policy in favor of "efficient, expeditious economic administration of bankrupt estates."

The district court took evidence on the question what administrative burdens were imposed by the requirement that taxes were to be withheld, paid over and duly accounted for by the bankruptcy trustee. The district court noted (as the referee had previously) a bankruptcy practice in the Southern District of New York, concurred in by IRS, of deducting 25 per cent of gross wage claims, covering both income and social security taxes, and paying it in one check to the Director of Internal Revenue without allocation to the various individual taxpayers. Further evidence indicated that a junior accountant or clerk with payroll records could make the 25 per cent calculations quite readily and could also fill out forms 941 and W-3 for the Government and forms W-2 for the individual employees respectively. On the basis of this evidence the district court, in an opinion printed at 341 F. Supp. 647 (S.D.N.Y. 1972), reversed the referee's order that the trustee was not required to withhold taxes or file the necessary forms. The court then went on to hold, relying upon *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96 (3rd Cir. 1964), that withholdings were not "expenses of administration" as held in *United States* v. *Fogarty, supra*, but rather were entitled only to a fourth priority as taxes "legally due and owing" to the United States by the bankrupt. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104(a)(4). In reaching this decision, the court also referred to *In re International Match Corp.*, 79 F.2d 203 (2d Cir.), *cert. denied sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652 (1935), for the proposition that "before a tax could be found to be legally due and owing by the bankrupt . . . enough must have been known about the basis of the tax to make the tax computable or 'knowable' before bankruptcy, although not collectible until after adjudication." 341 F. Supp. at 656. As to the City of New York's claim, the district court held that since the City tax was not even enacted until 1966 [3] there were no taxes that could be said to be legally due and owing to it in September, 1964, when the Chapter XI proceeding was filed, and hence the City had no claim, under *In re International Match Corp., supra*. For the reasons which we state hereafter, we agree with the district court insofar as it required withholding and filing the prescribed forms, but disagree as to the order of priority assigned by it to withholdings, as well as to its treatment of the claim of the City of New York.

The first issue is whether a bankruptcy trustee must withhold under federal income tax law. The Internal Revenue Code of 1954, § 3401(a) defines "wages" as "all remuneration . . . for services performed by an employee for his employer. . . ." Were we to face this question afresh, an argument might be made that payments made by a bankruptcy trustee for wages earned before bankruptcy are really wage claim distributions. For example, as pointed out to us by the trustee, a solvent employer required to pay a judgment for disputed wages earned might not be paying "wages." *Cf.* Rev. Rul. 55-520, 1955 Int. Rev. Bull. No. 2 at 393-94 (compromise settlement for cancellation of employment contract not wages for withholding or FICA); Rev. Rul. 69-136, 1969 Int. Rev. Bull. No. 1 at 252-53 (sums paid former employees while in military service not wages). Further, it could be advanced that the bankruptcy trustee is not an "employer" since he has no "right to control and direct," 26 C.F.R. § 31.3401(c)-

[3] New York City has had since July 1, 1966, a tax on residents as well as nonresidents earning wages in New York that tracks the federal tax (with limited immaterial modifications), New York City Admin. Code § T46-11.0, 12.0, and contains appropriate withholding provisions. New York City Admin. Code, Ch. 46, Titles T (residents) and U (non-residents). The rate of the tax is agreed upon here as 1 per cent.

1(b), the "individual performing services," 26 C.F.R. § 31.3401(c)-1(a), that is, the wage claimant. *See In re Park Brewing Co.*, 49 F. Supp. 750 (W.D. Mich. 1942). *But see* Int. Rev. Code of 1954, § 3401(d)(1) (defining "employer" as "the person having control of the *payment of* . . . wages . . . ." [emphasis supplied]);[4] *Educational Fund of the Electrical Industry* v. *United States*, 426 F.2d 1053 (2d Cir. 1970) (payments to union members attending school which under collective bargaining agreement derived from employers but were paid out by union trust denominated as "educational fund" constituted "wages" for withholding, and educational fund held to constitute "employer" under § 3401(d)(1)).

We are not writing on a clean slate, however. *United States* v. *Fogarty, supra*, decided in the Eighth Circuit has been followed first in the Sixth, *United States* v. *Curtis*, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950), and then in the Ninth Circuits on this point. *Lines* v. *State Department of Employment*, 242 F.2d 201 (9th Cir.), *rehearing denied with opinion*, 246 F.2d 70, *cert. denied*, 355 U.S. 857 (1957). *See also In re Connecticut Motor Lines, Inc.*, 217 F. Supp. 330 (E.D. Pa.), *supplemented* 223 F. Supp. 189 (1963), *rev'd on other grounds*, 336 F.2d 96 (3rd Cir. 1964). While *Fogarty* and its fellows have been criticized sharply by writers in the bankruptcy field,[5] there is no decision of any court outstanding to the contrary on the point of necessity of withholding.

Indeed, as was found below, until it was decided to make a test case of this one—and we are appalled that

[4] The trustee suggests that he does not have "control" because payment requires an order of the court and the referee's countersignature. But the trustee applies for the order and has title to the funds to be paid, and when he sends the checks out he surely has "control of the payment."

[5] 3A Collier on Bankruptcy ¶ 64.202 at 2119 n. 1 (14th ed. 1972); Hiller, *supra* note 2.

almost nine years elapsed from the time the wages were earned until the case came to us[6]—the bankruptcy trustees, at least in the Southern District of New York, managed perfectly well with the rough deduction of 25 per cent and remittance of that sum to the Director. The trustee's and referee's parade of horribles relating to computations, employment of accountants, completion of forms, etc., was quite deflated by the court below in its findings,[7] and especially its conclusion that "Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment." 341 F. Supp. at 654. The result in Fogarty at least has the virtue that wage earners themselves do not have the job of determining their individual FICA taxes or figuring how to report them so as to obtain full social security credit therefor.

It may be that a dust cloth will be needed to wipe the cobwebs away from the files in which the wage and payroll records for the quarter in question are stored, now that so much time has gone by, but the amount of effort required on the trustee's part in a bankruptcy matter involv-

[6] In this connection it might be noted that even the referee whose criticism of *Fogarty* was heavily relied on by the referee here refused to create a test case challenging the *Fogarty* rule in his circuit because he realized the "hardship that a protracted delay would entail" to the needy coal miners involved in his case. Hiller, *supra* note 2, at 54.

[7] The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee of the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office. 341 F. Supp. 647, 653.

ing the sums that this one does is relatively small, even though 413 wage claimants are involved. That effort probably doesn't begin to match that which will be required of a conscientious trustee to track down the present addresses of the former employees so that they may receive their long overdue wages in the mail, efforts which could largely have been avoided had distributions been made when they first could have been, several years ago. We thus hold that the trustee, as a person who substantially controls the payment of wages, Int. Rev. Code of 1954, § 3401(d)(1), is an employer for withholding tax purposes and must withhold.

It follows that as employer the trustee must file the requisite forms, including 941, W-2 and W-3, as he was ordered to do below. *Cf. Nicholas* v. *United States*, 384 U.S. 678, 692-93 (1966) (trustee in bankruptcy held under an Int. Rev. Code of 1954, § 6011(a) obligation to file returns for taxes incurred by debtor in possession). We hold also that he may withhold on the 25 per cent basis which the court below found, with no real dispute here, represents an IRS attempt to facilitate bankruptcy administration on quite a practical basis. We see no objection to this commonsense approach, for if there is an overpayment the employee can file for a refund. Of course, as income or social security taxes change—and the latter have increased .65 per cent from 1971 to 1973—the 25 per cent may have to be adjusted slightly.[8] Perhaps Congress will

[8] It should be remembered that these wage earners are in the highest degree of likelihood on the cash basis, Int. Rev. Code of 1954, § 446(a) & (c), so that the rates of tax in effect in the year of *payment* as opposed to the year of wage-earning or the year of the referee's order permitting payment govern. *Muhleman* v. *Hoey*, 124 F.2d 414, 415 (2d Cir. 1942); 2 Mertens, The Law of Federal Income Taxation § 12.42 at 179 (1973):

ultimately be of assistance here. But in any event the 25 per cent figure still seems a sound one and one easy to compute.

To which, if any, of the five priorities under § 64 of the Bankruptcy Act, note 2 *supra*, then, are withholdings on wage distributions to be assigned? The *Fogarty* case held that they should be classified as administration expenses, that is, in the first priority. *See also Lines* v. *State Department of Employment*, *supra*. But "the costs and expenses of administration," § 64(a)(1) of the Bankruptcy Act, 11 U.S.C. § 104(a)(1), must in general relate to the preservation or development of the bankrupt's assets. *See, e.g., Adair* v. *Bank of America National Trust & Savings Association*, 303 U.S. 350, 361 (1938). We agree that the Third Circuit's criticism of *Fogarty* and *Lines* in *In re Connecticut Motor Lines, Inc.*, *supra*, 336 F.2d at 99-102, *noted*, 63 Mich. L. Rev. 1103 (1965), 40 N.Y.U.L. Rev. 360 (1965), 19 Rutgers L. Rev. 546 (1965). *See also Denton & Anderson Co.* v. *Induction Heating Corp.*, 178 F.2d 841, 843-44 (2d Cir. 1949) (commissions accruing after bankruptcy on goods ordered but not filled prior thereto held *not* entitled to first priority status). By according (a)(1) status to withholding taxes they would take priority over the wages on which they were based. In *Lines*, indeed, dividends which would have gone to wage earners were depleted by an employer's tax payment to the unemployment insurance fund. *See* 56 Mich. L. Rev. 631, 633 (1958).

The doctrine that payments of compensation are income to a taxpayer on a cash basis in the year of receipt, as distinguished from the year in which the compensation is earned, is too firmly embedded in the income tax law to permit of any question.

Withholding of social security taxes is also done "by deducting the amount of the tax from the wages *as and when paid*." Int. Rev. Code of 1954, § 3102(a) (emphasis supplied).

We do not agree, however, with the Third Circuit's treatment in *Connecticut Motor Lines* of withholdings as "taxes which became legally due and owing *by the bankrupt*" (emphasis supplied), and hence entitled to fourth priority treatment. Bankruptcy Act § 64(a)(4), 11 U.S.C. § 104 (a)(4).[9] The taxes are by law calculable only when the wage claims are paid and not until then, note 7 *supra*, regardless of any practice by IRS to accept a flat payment of a specified percentage such as 25 per cent. The taxes were never "due and owing by the bankrupt," which was Freedomland.[10] When a tax "cannot be computed as of the date of the petition in bankruptcy," it is not "due and owing by the bankrupt." *In re International Match Corp., supra.*

We agree, rather, with the very persuasive brief of the City of New York that the proper classification for the withholdings to be made is that of second priority wage claims. All of the withholding taxes, whether federal or

[9] The Seventh Circuit reached the same result *In re John Horne Co.*, 220 F.2d 33 (7th Cir. 1955), relying somewhat on our own *Pomper* v. *United States*, 196 F.2d 211 (2d Cir. 1952). Both *Horne* and *Pomper*, however, dealt with wages actually paid before bankruptcy, not the case here. *United States* v. *Curtis*, 178 F.2d 268 (6th Cir. 1949), *cert. denied*, 339 U.S. 965 (1950).

[10] It is for this reason we reject the argument made by the Third Circuit, *In re Connecticut Motor Lines, Inc.*, 336 F.2d 96, 102-06 (3rd Cir. 1964), relied on by the district court here, 341 F. Supp. at 656-57, that a concerted legislative policy to reduce the priority of tax claims in bankruptcy requires a fourth priority classification for the withheld taxes here. The legislative policy discerned relates to taxes owed by the bankrupt, not by the bankrupt's employees. The fourth priority in bankruptcy relates historically and otherwise to taxes owed by the bankrupt. Similarly, the 64(a)(2) priority derives from 132 years of statutory history relating to the status of wage claims in bankruptcy, a history long precedent to the adoption in 1943 of what some will recall as "pay-as-you-go." Act of June 9, 1943, c.120 § 2(a), 57 Stat. 126, Int. Rev. Code of 1939, § 1621, as amended.

city, derive from the payments which will be made to the wage claimants. Int. Rev. Code of 1954, §§ 3402, 3101; New York City Admin. Code § T46-51.0 and § U46-8.0. The claimants are credited with the withheld amounts toward their income taxes. Int. Rev. Code of 1954, § 31(a); New York City Admin. Code § T46-53.0 and § 46-10.0. Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part. *Cf. In re Quakertown Shopping Center, Inc.*, 366 F.2d 95 (3rd Cir. 1966) (IRS can levy upon the claim of a taxpayer-creditor against a bankrupt estate without approval of bankruptcy court).

In our view when wage claims are ordered to be paid by the bankruptcy court they should be segregated and the tax monies due held as trust funds. Int. Rev. Code of 1954, § 7501(a); New York City Admin. Code § T46-55.0 and § U46-12.0. It is true that *United States* v. *Randall*, 401 U.S. 513 (1971) (5-4 decision), held that where a debtor in possession failed to obey an order of the bankruptcy court to deposit withheld taxes in a special tax account, the Bankruptcy Act's (a)(1) priority for costs and expenses of administration would override any claim pursuant to 26 U.S.C. § 7501(a) that the withheld taxes "shall be held to be a special fund in trust for the United States." *But cf. In re Airline-Arista Printing Corp.*, 267 F.2d 333 (2d Cir. 1959), and *City of New* v. *Rassner*, 127 F.2d 703 (2d Cir. 1942), referred to in *United States* v. *Randall, supra*, 401 U.S. at 519 (dissenting opinion). *Randall*, however, did not reach the question before us. Rather, it was concerned only with vindicating the Bankruptcy Act's "policy of subordinating taxes to costs and expenses of administration." 401 U.S. at 517. That policy is fully upheld by placing the withheld taxes here in a second priority position along with the wages that create

them. In other words, the trust which arises is subject to the prior payment of the statute-specified costs and expenses of administration, but exists nevertheless as to withholdings on wage claims allowed.[11] In this view, contrary to the view of the Third Circuit in *Connecticut Motor Lines, supra,* 336 F.2d at 107, there is no necessity for the Government (or City) to file proofs of claims for withholdings. Since withholding tax arises only when wage claims are allowed it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt,* not the case here. The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholdings due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. In this respect we agree with the court below.

There remains for consideration only the question whether New York City may obtain withholding taxes on the wage claims paid since there was not even a city income tax in effect when the wages were earned. But we have already pointed out that the wage earners here are in all probability on the cash basis, note 7 *supra,* so that regardless of when the wages were earned, they are income and taxable in the year received. As we have already said, liability for withholding arises when the wage claims are paid. Int. Rev. Code of 1954, §§ 3402, 3101 and 31(a). The City in this respect is in the same position as

[11] The second sentence of § 7501 of the Int. Rev. Code of 1954 is consistent with this view:

> . . . The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to taxes from which such fund arose.

the federal government. New York City Admin. Code §§ T46-51.0 and U46-8.0; §§ T46-50.0 and U46-10.0. Wages are just as much a part of city "adjusted gross income," New York City Admin. Code § T46-12.0, as they are of federal. The fact that the city tax applies to wages earned before its effective date is not important since no vested rights are impaired. *See Welch* v. *Henry,* 305 U.S. 134, 146-51 (1938); *Milliken* v. *United States,* 283 U.S. 15, 20-24 (1931); *Kentucky Union Co.* v. *Kentucky,* 219 U.S. 140, 152-53 (1911) ("Laws of a retroactive nature, imposing taxes . . . and not impairing vested rights, are not forbidden by the Federal Constitution"). *See also Lynch* v. *Hornby,* 247 U.S. 339 (1918) (federal income tax law constitutionally permits taxation of dividends paid out of surplus accumulated before date of act); *Neild* v. *District of Columbia,* 110 F.2d 246, 253 (D.C. Cir. 1940). We conclude that the City is as entitled to its withholding tax as the federal government is to its taxes.

We add only that to the extent there is now a conflict among the circuits as to priorities of withholding taxes on pre-bankruptcy wages earned—the Eighth and Ninth Circuits going for the first, the Third for the fourth and the Second for the second—correction may come either from Congress or the High Court. It is a pity that the wage claimants here had to wait so long for the case to wend its way to our court, and that so many of them were involved. Nevertheless the question has some significance in the administration of bankrupt estates so that it is perhaps well that after the 25 years that have elapsed since *Fogarty* the matter might receive some further congressional or judicial attention.

We reverse and remand for the entry of judgment in accordance with this opinion.

Relevant Docket Entries of District Court

United States District Court

FOR THE SOUTHERN DISTRICT OF NEW YORK

64—B—727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Bankruptcy Court

9/15/64—Filed petition, schedules, statement of affairs, statement of executory contracts and affdvt. of Hyman Green pursuant to Rule XI-2—referred to Referee Ryan.

8/30/65—Referee signed Order of Adjudication and Approval of Appointment of Trustee, (William Otte) ($100,000.00).

12/ 7/65—Referee signed Order Barring filing of Administration claim to January 30, 1966 (with Trustee).

11/ 7/69—Filed N/M for order authorizing payment of wage claims without deduction for payroll taxes, etc. returnable November 17 at 10:00.

6/16/70—Filed reply memorandum of The City of New York in re: withholding of taxes from priority wage claims to be paid.

1/28/70—Filed Referee's decision on Trustee's application with respect to wage claims.

Relevant Docket Entries

2/26/70—Referee signed order directing Trustee to declare dividend upon class 2 Priority wage claims etc.

3/ 2/70—Filed Petition to Review re: order signed 2/26 directing Trustee to declare dividend upon Class 2 Priority Wage claims, etc.

3/ 5/70—Filed Referee's certificate on petition for review.

3/ 5/70—Filed affidavit of service re: order signed on 2/26/71.

District Court

3/ 9/71—Filed referee's certificate on petition for review. Ret. 3-23.

3/ 9/71—Filed one portfolio on petition for review, to be returned to Referee.

3/11/71—Filed application for order to show cause restraining the trustee from making distribution on wage claims until Govt's petition for review of referee's order is decided . . . BONSAL, J. ret. 3-16-71.

3/16/71—Filed memo endorsed on order to show cause "Motion granted no opposition. So ordered. Bonsal, J."

4/19/71—Filed memorandum of law of City of N.Y. on its petition for review.

4/21/71—Filed memorandum of law by the U.S. in support of its petition for review.

2/29/72—Filed opinion #38292 * * * petition to review Nov. 7-69 the trustee moved before the referee for an order authorizing him to pay 413 priority wage claimants without withholding there from U.S. N.Y. STATE OR N.Y. CITY income taxes.

This relief was granted. * * * the decision and order of referee are reversed * * * Submit order on five days notice . . . MOTLEY, J. . . . copy sent to Referee.

3/ 2/72—Received from Clerk of Court copy of Judge Motley's opinion. Re: Federal Withholding Taxes.

3/ 6/72—Filed transcript dated Jan. 20-21-1972.

3/23/72—Filed Order that * * * the petition by the City of N.Y. to review the referee's order of 2-26-71 is denied, and ordered that the petition by the U.S. to review the referee's order of 2-26-71, be and it hereby is granted * * * Motley, J.

3/24/72—Received from Clerk of Court copy of Judge Constance B. Motley's order re: granting referee's order of 2/26/71.

4/18/72—Filed notice of appeal from order of Judge Motley, dated March 22, (and filed in the Clerks Office March 23, 72) denying the petition by the City of New York to Review the order of Judge Ryan—filed by: Howard Karasik, Atty for William Otte, Trustee in Bankruptcy of Freedomland, Inc., Bankrupt—1290 Ave of Americas, NYC—

4/19/72—copies mailed to: Susan Freiman, Esq. Asst. U.S. Atty, U. S. Courthouse, Foley, NY—Atty for the U.S. Government.

Raymond Herzog, Esq. Asst. Corp. Counsel, Municipal Building NYC, Atty. for the City of New York.

Louis J. Lefkowitz, (Atty for State of N.Y.) Attorney General, State of New York, State Office Building, 80 Centre St., NYC (Copies mailed on 4-19-72).

5/ 2/72—Filed notice of appeal from so much of the order of Judge Motley in this proceeding dated March 22, 72, and entered in the Clerk Office on March 23, 72, as gives the Federal withholding taxes a priority under Section 64a(4) of the Bankruptcy Act, filed by Susan Freiman, AUSA.

US Atty for the Southern District
Foley Square, NYC

5/ 3/72—Copies Mailed 5-3-72 to
Raymond Herzog, Esq. Asst. Corp. Counsel, Municipal Bldg, NY &

Louis J. Lefkowitz, Atty General, State of NY, State Office Bldg, 80 Center St., NYC &

Howard Karasik, Esq. 1290 Ave. of Americas, NYC &

David Shandalow, Esq., 1501 Bway, NYC

5/19/72—Filed notice of appeal from so much of the order of Judge Motley dated March 22, 72 and entered in the Clerk's Office on March 23, 72, (1) denying the petition by the City of NY to review the order of Referee Ryan dated Feb. 26, 71 and (2) giving the federal withholding taxes only a fourth priority under Sec. 64a (4) of the Bankruptcy Act, filed for: J. Lee Rankin, Corp. Counsel of the City of N.Y. Atty for the City of NY . . . by Raymond Herzog, Asst. Corp. Counsel . . . Office and PO Address: Municipal Bldg NYC.

3/22/72—Copies Mailed on May 22, 72 to:

Howard Karasik, Esq. Atty of Trustee,
1290 Ave. of Americas, NYC

Relevant Docket Entries

Whitney North Seymour, Jr.
US Atty for S.D. of N.Y.
U.S. Courthouse, Foley Square, NY

Hon. Louis J. Lefkowitz, Atty General of the State of NY
80 Centre St., NYC

David Shandalow, Esq. Atty for Bankruptcy Lawyers Bar Asso.
1501 Broadway, NYC

Clerk of the U.S. Court of Appeals for the Second Circuit
U.S. Courthouse, Foley Square, NYC.

5/23/72—Received notice from Howard Karasik, Atty for Trustee that record on appeal has been certified and transmitted to the U.S. Court of Appeals 5-23-72.

6/27/72—Filed Stipulation that it is hereby agreed, by and among the attorneys for the respective appellants that the attached copies of the following documents (the originals of which were heretofore filed in this Court on the date set after the name of the document, but which cannot now be found among the Court's records despite diligent search therefor) be substituted for the missing originals and included by the Clerk of the Court in a supplemental record to certified and transmitted to the Second Circuit.

6/27/72—Rec'd. notice that supplemental record on appeal has been certified and transmitted to the U.S. Court of Appeals for Second Circuit on June 27, 1972.

Petition in Proceedings Under Chapter XI

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

64—B—727

In the Matter

—of—

FREEDOMLAND, INC.,

Debtor.

SCHEDULE A.—STATEMENT OF ALL DEBTS OF DEBTOR

Schedule A-1

Statement of all creditors to whom priority is secured by the act.

Claims which have priority.	Reference to ledger or voucher.	Names of creditors.	Residences (if unknown, that fact must be stated.)	When and where incurred or contracted.	Whether claim is contingent, unliquidated or disputed.	Nature and consideration of the debt, and whether incurred or contracted as partner or joint contractor, and if so, with whom.	Amount due or claimed.
Wages due workmen, servants, clerks, or traveling or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the debtor, to an amount not exceeding $600 each, earned within three months before filing the petition.		There are approximately $80,000 in wages due employees as set forth in the debtor's payroll records for the four-month period immediate preceding the filing.					$80,000.00

Notice to File Claims

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Bankrupt. No. 64B727.

In the Matter

—of—

FREEDOMLAND, INC.,

NOTICE TO FILE CLAIMS

NOTICE IS HEREBY GIVEN that pursuant to an order made by HONORABLE EDWARD J. RYAN, Referee in Bankruptcy, dated December 7, 1965, all persons, firms, corporations, taxing authorities and agencies having claims against the above named bankrupt estate, the debtor-in-possession or the trustee, arising subsequent to the filing of the petition for arrangement under Chapter XI of the Bankruptcy Act on September 15, 1964, be and they hereby are directed to file with MARTIN J. CAINE, attorney for the trustee, at 280 Madison Avenue, Borough of Manhattan, City of New York, on or before January 30, 1966, an affidavit properly sworn to, setting forth the nature and amount of such claims, the dates when such claims were incurred and created, and specifically setting forth that such claims arose subsequent to the date of the filing of the petition for arrangement under Chapter XI of the Bankruptcy Act on September 15, 1964, and prior to the date of adjudication on August 30, 1965, and that upon the failure of such firms, persons, corporations, taxing authorities, or taxing agencies, to file such claims on or before said date, they be precluded and forever barred from making any claim thereafter

Notice of Claim

against the estate of the above named bankrupt or against the funds in the hands of the trustee, or against the trustee.

CLAIMS FOR OBLIGATIONS INCURRED BY THE BANKRUPT PRIOR TO SEPTEMBER 15, 1964 WERE REQUIRED TO BE FILED BY APRIL 15, 1965. IF YOU HAVE ALREADY FILED CLAIMS FOR AN OBLIGATION INCURRED PRIOR TO SEPTEMBER 15, 1964, IT IS NOT NECESSARY TO FILE ANOTHER CLAIM AT THIS TIME. CLAIMS FOR OBLIGATIONS INCURRED AFTER SEPTEMBER 15, 1964 WHICH HAVE ALREADY BEEN FILED WITH THE REFEREE IN BANKRUPTCY OR THE TRUSTEE NEED NOT BE FILED AGAIN.

December 7, 1965

WILLIAM OTTE, Trustee

MARTIN J. CAINE
Attorney for Trustee
280 Madison Avenue
New York, N. Y. 10016

Decision on Trustee's Application with Respect to Wage Claims

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

In Bankruptcy No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Before: HONORABLE EDWARD J. RYAN,
Referee in Bankruptcy.

MARTIN J. CAINE, Esq.,
280 Madison Avenue
New York, New York
Attention: HOWARD KARASIK, Esq.

HONORABLE WHITNEY NORTH SEYMOUR, JR.
United States Attorney for the
Southern District of New York
United States Courthouse, Foley Square
New York, New York
Attention: Miss SUSAN FREIMAN
Assistant United States Attorney

HONORABLE J. LEE RANKIN
Corporation Counsel of the
City of New York
Municipal Building
New York, New York
Attention: CORNELIUS ROCHE, Esq.
Assistant Corporation Counsel

Decision on Trustee's Application with Respect to Wage Claims

HONORABLE LOUIS J. LEFKOWITZ
Attorney General of the
State of New York
80 Centre Street
New York, New York

Freedomland, Inc. filed its petition in proceedings for an arrangement under Chapter XI, Section 322, of the Bankruptcy Act on September 15, 1964. At the first meeting of creditors, held on October 15, 1964, William Otte was nominated as the person to be appointed trustee in bankruptcy if it should become necessary to administer the estate in bankruptcy. The arrangement proceedings did fail and, on August 30, 1965, the debtor was adjudicated a bankrupt. Mr. Otte qualified by filing his bond and commenced upon the administration of the estate.

Mr. Otte, the trustee in bankruptcy, now moves for an order:

"1. Authorizing and directing the trustee, upon the declaration of a dividend upon class (2) priority wage claims in this proceeding, to distribute to such claimants the full amount of their respective claims as filed and allowed, without withholding or deduction of United States income or social security taxes.

2. Declaring that the trustee is not required under law to

(a) withhold or deduct from any distribution of a dividend to class (2) priority wage claimants income withholding, social security, or any other payroll taxes claimed by the United States, the State of New York, or the City of New York;

(b) to pay to the United States, the State of New York, or the City of New York, any amounts whatever in connection with the distribution of a dividend upon class (2) priority wage claims, other than such amounts as are set forth in a class (1) administration expense claim or a class (4) priority tax claim filed and allowed in this proceeding;

(c) to file any report or tax return with the taxing authorities of the respondents in connection with the distribution of a dividend upon class (2) priority wage claims;

(d) to prepare or distribute to class (2) priority wage claimants, or to file with the taxing authorities of the respondents, wage and tax statements (forms W-2, etc.) in connection with the distribution of a dividend upon class (2) priority wage claims;

and declaring that the trustee, individually and as such trustee, shall have no liability whatsoever to any of the respondents by reason of any alleged failure to perform any of the functions set forth in subparagraphs '(a)', '(b)', '(c)' and '(d)'.

3. For such other relief as is proper."

This application is made on notice to the United States Attorney for this District, the Attorney General of the State of New York and the Corporation Counsel of the City of New York.

The application of the trustee, *in extenso*, except for the formal parts, is as follows:

"1. Applicant has applied for an order declaring a dividend class (2) priority wage claims filed and allowed in this proceeding.

2. By directive issued to Referees in Bankruptcy, the Internal Revenue Service of the United States has set forth that upon distribution of a dividend to any class (2) priority wage claimant, trustees in bankruptcy are required to:

(a) either ascertain the exact amount of United States income and social security taxes required to be withheld and deducted from such distribution and to withhold and deduct such amounts;

(b) or, alternatively, to deduct 25% of any such distribution on account of United States income and social security taxes;

(c) to file forms 941 with the Internal Revenue Service for any amounts withheld and deducted upon such distributions and to pay to the Internal Revenue Service such amounts withheld and deducted;

(d) prepare and distribute to wage claim distributees and file with the Internal Revenue Service wage and tax statements (forms W-2).

3. Applicant submits that the requirements imposed by this directive are contrary to law for the reasons that:

(a) the distribution of a dividend upon a class (2) priority wage claim filed and allowed in a bankruptcy proceeding is not the payment of wages within the meaning of Internal Revenue

Code Section 3401, et seq., or within the meaning of any other governing provision of United States or New York law;

(b) in any event the provisions of the Bankruptcy Act governing the filing and allowance of and distribution upon claims of the United States against the bankrupt estate supervene any conflicting provisions of the Internal Revenue Code and Regulations.

4. Applicant requests the entry of an order clarifying and determining the responsibilities of the trustee with respect to the onerous functions imposed by the directive, for the following reasons germane to the administration of this estate:

(a) There are 413 class (2) priority wage claims filed in this proceeding. The preparation of tables of distribution, the preparation and filing of forms 941, reporting withholding and deductions for each distributee, and the preparation and distribution to the distributees of forms W-2 in each case, would impose a massive burden upon the administration of this estate, to the detriment of its creditors, since applicant would be obliged to incur substantial expenses for accounting and legal services which would otherwise be unnecessary.

(b) As a practical matter, it would be impossible for the trustee to ascertain the exact United States payroll deductions in the case of each of the 413 priority wage claims filed in this proceeding. Even if it were possible to ascertain this data in every such case, the expense of such ascertainment would impose an addi-

tional massive and onerous burden upon the administration of this estate and substantial additional expense.

(c) Applicant believes that the alternative deduction of 25% would constitute a substantial tax over-payment to the United States in the case of 98% or more of the priority wage claimants in this proceeding. It has been applicant's experience that the preponderance of priority wage claim distributees in bankruptcy proceedings who are entitled to refunds of taxes withheld by bankruptcy trustees never in fact apply for or obtain such refunds. The inevitable end result is the imposition of hardship or partial loss upon such distributees with consequent improper windfall to the United States. Applicant believes this result is contrary to public policy and to law. As trustee, applicant is charged with the responsibility of the protection of the common interests of a class of creditors of the estate against hardship or loss sustained pursuant to a directive which is contrary to public policy and to law.

5. The State and City of New York have been made parties respondent to this application, since applicant believes that under prevailing law the rights of each to deduction, remittance, and reporting of withholding taxes upon class (2) priority wage claim distributions are not less than those of the United States, and it is necessary that the trustee obtain a declaration that neither applicant as trustee nor the estate has any obligation to perform such functions to or for any taxing authority."

In its answer, the United States admits the allegations of paragraphs 1 and 2 of the trustee's application; denies the allegations of paragraph 3 and admits so much of paragraph 4 as alleges that there are 413 priority wage claims which have been filed. The United States contends, in paragraph 4 of its answer, that:

> "4. The trustee is required by law to withhold taxes from distributions to wage claimants, to file with the Internal Revenue Service information returns (Form 941) reporting such withholding, and to transmit to wage claimants statements reporting such withholding (Forms W-2)."

And, finally, the United States in the fifth paragraph of its answer contends that this court has no jurisdiction to pass on this matter, and that it is without jurisdiction prospectively to absolve the trustee from potential liability for failure to withhold and report.

The State of New York defaulted in appearing and in pleading to the application of the trustee.

The City of New York, by answer, admits the allegations contained in paragraphs numbered 1, 2 and 5 of the trustee's application. The City also denies the allegations contained in the third numbered paragraph of the application, and it alleges that it is without knowledge or information sufficient to form a belief with respect to the allegations contained in paragraph numbered 4, except that the City of New York admits that the trustee requests the entry of an order authorizing payment of wage claims without deduction of payroll taxes. For a "Second Defense" the City of New York:

> "4. Alleges that William Otte, trustee in bankruptcy, is required

> (a) to deduct and withhold from any distribution of a dividend to wage claimants the New York City Personal Income Tax and/or the New York City Earnings Tax due upon such payments of wages;
>
> (b) to file a return and forward a correct remittance to the New York City Income and Excise Tax Bureau in payment of the income and/or earnings taxes required to be withheld as aforesaid;
>
> (c) to furnish to the aforesaid wage claimants and to the New York City Income and Excise Tax Bureau completed copies of the City of New York Wage and Tax Statement (Form NYC-2); and
>
> (d) to comply with all other requirements for withholding tax from wages under the New York City Personal Income Tax on Residents (Title T of Chapter 46 of the Administrative Code of the City of New York) and the New York City Earnings Tax on Nonresidents (Title U of Chapter 46 of the Administrative Code of the City of New York)."

A scrutiny of these pleadings shows that they raise no issues of fact but, rather, that "an issue of law" is raised. The respondents' controverting of the "allegations" of paragraph 3 of the application merely argues the conclusion of law contained in that paragraph. The respondents' admission of the allegations contained in paragraph 2 of the application does not establish the "fact" stated therein; the Internal Revenue Service of the United States has not undertaken to define the duties of trustees in bankruptcy, "[b]y directive issued to Referees in Bankruptcy, ..." The duties of trustees in bankruptcy are defined, *inter alia*, in Bankruptcy Act, Section 47, and General Order in Bankruptcy 17, adopted by the Supreme Court of the United States.

Decision on Trustee's Application with Respect to Wage Claims

To the extent that it might be said that issues of fact were raised by reason of the denial of the allegations contained in paragraph 4 of the application, the parties declined the invitation of the court to adduce evidence and, instead, relied upon "the law".

It appears, then, that on a most meager record, the undersigned is called upon to determine as a "matter of law" which of two clearly desirable, but countervailing objectives is to be preferred, viz., the collection of taxes or the efficient inexpensive administration of estates in bankruptcy. Compare the analogous problem presented by the contentions of the litigants in *United States* v. *First National City Bank,* 396 F.2d 897 (2d Cir. 1968) ["bank secrecy"].

The argument that this court is without jurisdiction is without merit. In the instant case, the trustee in bankruptcy requests directions from the court so that he may fulfill his statutory duty to ". . . collect and reduce to money the property of the estates for which they are trustees, *Under the direction of the court,* and close up the estates as expeditiously as is compatible with the best interests of the parties in interest; . . . ." Bankruptcy Act, Section 47a (1). Such directions of the court may be implemented by ". . . such orders . . . as may be necessary for the enforcement of the provisions of this Act; . . . ." Bankruptcy Act, Section 2a (15). Alternatively, the tax authorities might be deemed to have filed contingent, unliquidated claims for taxes in their papers submitted in the instant controversy, and the court clearly has jurisdiction to determine the validity of such claims. Bankruptcy Act, Section 2a (2), 2(A).

Decision on Trustee's Application with Respect to Wage Claims

The gist of this controversy is whether a trustee in bankruptcy is an "employer" who is paying "wages" when he makes a distribution to wage claimants who are entitled to priority in distribution of estate assets by virtually Section 64a(2) of the Bankruptcy Act, so that as such "employer" the trustee is required to comply with the applicable withholding and reporting provisions of the Federal, State and City tax laws.

The tax authorities rely primarily upon the rule of *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947) and its progeny including *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. den.* 339 U.S. 965 (1950), and *In re Daigle,* 111 F.Supp. 109 (D.C., Maine, 1953). Clearly, *Fogarty* supports the position taken by the tax authorities in the instant case. For the reasons hereinafter stated, I have concluded that *United States* v. *Fogarty* was wrongly decided. I am of the opinion that I am not bound by that or any other controlling decision. *Fogarty* was mentioned in passing in this Circuit in *Educational Fund of the Electrical Industry* v. *United States,* 426 F.2d 1053 (2d Cir. 1970). In mentioning this case, however, the Court of Appeals for this Circuit merely cited *Fogarty* for the proposition that:

> "The purpose of Section 3401(d)(1) is to provide that the person actually paying the wages (instead of the employer who makes a payment into a fund for the benefit of all his employees) is obligated to withhold the taxes."

Educational Fund of the Electrical Industry was essentially a "tax" case without bankruptcy or other competing federal over-tones which are found in the instant controversy.

Decision on Trustee's Application with Respect to Wage Claims

In my opinion, the basic vice of *Fogarty* was its consideration of the problem before it merely as a tax case, without giving due regard to the consequences to orderly, efficient, economical bankruptcy administration which necessarily ensue from that ruling. Little can be added to the lucid criticism of *Fogarty* by Referee Russell L. Hiller of Reading, Pennsylvania, in a paper entitled, "The Folly of the Fogarty Case" which was read at the Annual Conference of the National Association of Referees in Bankruptcy at Indianapolis on October 28, 1957.[1] As Referee Hiller pungently states:

> "In practice, as any Referee knows, the application of the Fogarty rule is sheer nonsense."

To apply the *Fogarty rule* in every bankruptcy case would impose a further burden on the administration of these estates which is entirely inconsistent with the objective of efficient expeditious economic administration of bankrupt estates.

Fogarty has been criticized even in authorities upon which the tax authorities in the instant case rely. In *In re Connecticut Motor Lines, Inc.*,[2] Judge Foreman said, *inter alia*:

> "The ultimate result in *Fogarty* rests on a number of cases which lend little support to that holding, and if anything, detract from the reasoning of the Eighth Circuit (footnote omitted)."

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[1] 32 Journal of the Nat'l Ass'n of Referees in Bankruptcy 54, April 1958 (photocopy annexed).

[2] 336 F.2d 96, 99 (3d Cir. 1964).

Decision on Trustee's Application with Respect to Wage Claims

In *United States* v. *Klein*,[3] the court observed: "We are not impressed with the reasoning of the court in the Fogarty case. . . ."

In practice, except in rare cases, no trustee in bankruptcy complies with State and City withholding and reporting requirements in the Southern District of New York at the present time. Again, except in rare instances, trustees in bankruptcy do not attempt to comply with Federal reporting requirements. In effecting distribution to wage claimants, 25% of the gross wage claims being paid is deducted and transmitted by one check to the Director of Internal Revenue without attempt to allocate the proportion of such "withholding tax" to the various wage claimants for appropriate credit. The origin of this practice was not explained in the instant proceedings. The record is also barren of any evidence of what is the practice in other districts.

I am of the opinion that compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and the letter of the Bankruptcy Act. Accordingly, I hold that a trustee in bankruptcy is not an employer who pays wages when he distributes dividends on account of wage claims, whether priority or general.

Settle an appropriate order consistent with the foregoing.

Dated: New York, New York
January 27, 1971.

/s/ EDWARD J. RYAN

EDWARD J. RYAN
Referee in Bankruptcy

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[3] 220 F.2d 33, 35 (7th Cir. 1955).

Journal of the Folly of the Fogarty Case*

By Referee Russell L. Hiller, Reading, Pa.

When your President, Lee Cazort, invited me to participate in your program, I pondered the question of what I might speak upon that would add a modicum of substance and interest to your program. I found the answer in my own experience as a referee. That experience involved the application of the rule and authority of the case of *U. S.* v. *Fogarty,* a case decided in 1947 by the United States Circuit Court of appeals for the 8th Circuit. My experience convinces me that the holding in that and the several cases that have since followed in its wake, are erroneous and unsound and their rule ought to be changed. As I view it, that change at this late date will have to be made through legislation.

It is now 10 years since the case of *U. S.* v. *Fogarty* was decided. During that period the principle established by that case has taken root. In 1949 the 6th Circuit followed in the case of *U. S.* v. *Curtis.* In 1953 the District Court in Maine (1st Circuit) followed with *In re Daigle.* In 1955 the 7th Circuit in *U. S.* v. *Klein* distinguished the Fogarty case on its facts; and in 1957 in the case of *Matter of Blackwood* the 9th Circuit extended the rule of the Fogarty case to a state tax claim. The time has arrived for some effective action to set aside the rule of the Fogarty case. That is the only reason I burden you with a discussion; for most of you are already familiar with the undesirable aspects of the rule of that case and how impracticable and burdensome is its application.

Briefly stated, *U. S.* v. *Fogarty* stands for the proposition that in making distribution on wage claims filed for prebankruptcy wages a trustee in bankruptcy is required to make appropriate deductions for income withholding taxes and social security taxes due the United States, which deductions are payable as an administration expense entitled to priority.

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* Paper read at Referees' Indianapolis Conference (Oct. 28, 1957).

In practice, as any Referee knows, the application of the Fogarty rule is sheer nonsense. Let me illustrate from my own experience.

In 1954 Hammond Coal Company, a Pennsylvania Corporation, was adjudged bankrupt. It conducted extensive coal mining operations in the anthracite coal fields in Pennsylvania under a lease from the Stephen Girard Estate in Philadelphia. The Girard Estate owned the mines. Hammond's property holdings were modest. Virtually the only tangible assets available for liquidation were 110 carloads of processed coal already in cars and some processed coal, stockpiled on the premises. Liquidation produced a fund of about $100,000.00. At the time of bankruptcy the company employed nearly 800 persons, to each of whom it owed wages earned within the statutory priority period. This resulted in nearly 800 wage claims being filed aggregating in excess of $200,000.00.

The Director of Internal Revenue at Philadelphia filed claims for income withholding, federal insurance contributions and federal unemployment taxes aggregating $491,000.00. At the audit of the trustee's account counsel for the Regional Director's Office at Philadelphia appeared and urged that in making distribution on each of the foregoing wage claims the trustee first make appropriate calculations and deductions for withholding and employment taxes, citing *U. S.* v. *Fogarty* (*supra*). The trustee protested the request as unreasonable and burdensome, urging (1) that neither he nor the Bankruptcy Court had at its disposal the staff and facilities necessary to perform the calculations involved, which included an examination of the withholding exemption statements of each employee; (2) that the hire of necessary skilled help to perform the task was unjustified as constituting an unwarranted financial burden to the estate, and (3) in any event, it appeared probable, if not a certainty, that the taxes thus paid would in turn be largely, if not entirely, recovered by the taxpayer

by way of tax refunds, since the bankruptcy occurred in the early part of the calendar year in 1954 and many claimants were still unemployed. As my Circuit, the 3rd, had not had occasion to pass upon this question, I was disinclined to accede to the government's request. Counsel for the Regional Director advised that refusal would result in review and appeal if necessary. With nearly 800 needy coal miners eagerly awaiting a payment on their wage claims, I acceded to the government's request in order to avoid the hardship that a protracted delay would entail. To accomplish the task, I authorized the hire of the bankrupt's former Comptroller, who was familiar with the payroll, to calculate the taxes and prepare a schedule of net payments due each wage claimant and the taxes thereon due the United States. That task cost the estate over $600.00 and resulted in a gross payment to the United States of $1,611.41 for withholding and $1,761.72 for employment taxes!

This practical application of the principle of the Fogarty case in my view demonstrates in a dramatic way the folly and utter absurdity of the rule of that case.

I will not attempt to reargue the Fogarty case. That would be futile. It is too late to follow such a course. What is needed at this late date is legislation; an amendment to Section 64 of the Bankruptcy Act providing specifically for an exclusion from tax deductions on payments of all wage claims, whether priority or general. However, I am not concerned here with the mode of amendment as much as I am with the need for it.

But I have not told you the whole story about the Fogarty case. It stands for more than the briefly stated proposition mentioned earlier. Let me review it and its progeny cases for you a bit more in detail. In doing so, substance will be added to what is so far only premise.

The Fogarty case had its inception in December 1942 when Inland Waterways, Inc. filed a Chapter X petition.

At the time the Company employed 200 persons and did shipbuilding for the U. S. Navy in the vicinity of Duluth, Minn. It owed wages to its employees earned within the priority period approximating $44,000.00, for which claims were later filed. Fogarty was appointed trustee with power to continue the business until a plan of reorganization could be devised and approved or until adjudication, should that become necessary. Operations did not prove feasible and were ultimately discontinued. In June 1945 the Company was adjudged a bankrupt. The Court thereafter ordered a 25% dividend to be paid to wage claimants. At this juncture the Collector of Internal Revenue demanded that in making such distribution the trustee file returns, withhold and pay Federal Insurance Contributions taxes and Income withholding taxes. The trustee declined, whereupon the Collector filed with the bankruptcy court a claim for such withholding taxes as an expense of administration Review and appeal followed. Without burdening the discussion with tedious detail regarding a government set-off and other extraneous facts, the Court on appeal sustained the government's position, in the course of which it reached the following conclusions:

(a) The assessment of employment taxes on wage dividends is valid.

(b) For such purpose a trustee in bankruptcy is an "employer" within the meaning of the relevant taxing statutes.

(c) Under the relevant taxing statutes, the term "employer" applies [to a bankruptcy trust as an] employer under the income withholding tax provisions of Internal Revenue Code, and is liable for the payment of taxes applicable to such wages.

(e) The amounts distributed by the trustee to wage claimants, constitute "wages" within the meaning

of the social security employment tax statutes and provisions of Income withholding tax statutes.

(f) Dividends to wage claimants do not lose their identity as "wages".

(g) The term "employer" as used in Treasury Regulations referable to income withholding taxes means the person paying such wages or having control of their payment.

(h) Social Security employment taxes as well as Income withholding taxes are payable as an expense of administration having priority, with respect to wages *earned* prior to the employers bankruptcy, and *paid* by the trustee under Court Order, because such taxes were not due and payable at the time bankruptcy proceedings were instituted, but only "as and when wages were paid".

Even a casual analysis of these propositions established in the Fogarty case renders it obvious that in rationalizing the problem before it, the Court was oriented in its thinking almost entirely to the taxing statutes and not at all to the Bankruptcy Act, especially to its provisions concerning priorities of payment.

Probably the most tenuous of all the propositions established in the Fogarty case are (1) that distributions made by a trustee to wage claimants constitutes "wages"; and (2) that the trustee in making distribution to wage claimants is an "employer" within the meaning of certain tax statutes. These propositions of course were essential to enable the Court to reach the result.

But I will not belabor the flimsy premises which the Court employed to support its reasoning and result. My purpose is directed more to show how the rule of the Fogarty case has grown and how unwise it is to permit it to remain in our system of jurisprudence.

Two years after the Fogarty case came the case of *U. S.* v. *Curtis* (*supra*). The Circuit was the 6th; the Bankrupt was Forest City Brewing Co.; the trustee was Curtis; and the Referee, Friebolin. The government, relying upon the Fogarty case, requested that deductions for income withholding taxes be made by the trustee on payments to wage claimants for wages earned before bankruptcy. The trustee declined; the referee disallowed the claim; on review the District Court affirmed and on appeal the Circuit Court reversed. On appeal, there was no appearance by the trustee. Despite that, however, the holding in the Fogarty case that such taxes are enforceable against the estate of the bankrupt as an expense of administration having priority, was just too much for the Court. Instead it expressly refrained from "reaching the question, base its decision or express any opinion" upon that portion of the Fogarty decision. Accordingly, in the Curtis case the withholding on wage dividends was approved, but the amount withheld was assigned a fourth priority only under Section 64.

The opinion of Referee Friebolin in the Curtis case is devastating in discrediting the propositons and reasoning in the Fogarty case and I commend it to your reading.

Next in 1953 was the U. S. District Court in Maine (1st Circuit) in the case of *In re*: *Daigle* (*supra*), where the Court embraced the rule of *U. S.* v. *Fogarty* completely.

And so the ball was rolling, gathering momentum as it rolled on, until its progress was somewhat impeded by the holding of the Circuit Court for the 7th Circuit in 1955 in *U. S.* v. *Klein* (*supra*), a case in which our dear friend Archie H. Cohen represented the debtor John Horne Co. The case originated in the District Court for the Northern District of Illinois in December 1951. After a Section 321 Chapter XI proceeding with the debtor in possession had miscarried, the debtor was adjudicated in October 1952. The government filed claims for federal unemployment and

withholding taxes for the calendar year ending December 31, 1951 and asked their allowance as an administrative expense. The trustee conceded the government's entitlement to priority under Section 64(a)(4), but denied the government's claim to priority under 64(a)(1). With respect to wages earned and paid subsequent to bankruptcy (when the debtor was in possession under Chapter XI) the trustee conceded a 64(a)(1) priority. Both Referee Wallace Streeter and the District Court supported the trustee's position. On appeal the Circuit Court affirmed, assigning to the government a fourth priority on its claim. The distinguishing characteristic between the Klein and the Fogarty cases lies in their facts. In the Klein case pre-bankruptcy wages had been both earned and paid before bankruptcy so that the government's claim was for "taxes legally due and owing by the bankrupt to the United States" and was entitled only to a fourth priority under 64(a)(4). In the Fogarty case pre-bankruptcy wages had been earned but had not been paid at the time of bankruptcy, with the result that the Court held there was no tax due and owing to the government at that time. Thereafter when claims for such wages were allowed and paid in the bankruptcy proceedings, they were subject to applicable laws and withholding which the Court then assigned a first priority.

But after distinguishing the Klein and Fogarty situations the Court was moved to observe that it was not impressed with the reasoning of the Fogarty case and went on to say: "the government would have the Court embrace what the government characterizes as 'the overall policy of the taxing statute.' Its contention, if accepted, might not do any violence to the taxing statute, but it would make a shambles of the Bankruptcy Act". It is at least doubtful whether the 7th Circuit will follow the Fogarty case when the matter comes up again on comparable facts.

In *Pomper* v. *U. S.* (CCA 2nd 1952) 196 F(2d) 211, the debtor filed a Chapter XI Proceeding on November 14,

1947 and was continued as a debtor in possession through September 1948. The debtor's Federal Unemployment taxes for the year 1947 became due January 31, 1948. The government claimed the entire unemployment tax for 1947 as an administrative expense entitled to first priority in payment. The Referee allowed the claim as a fourth priority only as to wages earned prior to November 14, 1947 when the bankruptcy proceeding was instituted and granted leave to the government to file an amended claim for that portion of the annual payroll tax due on wages paid out after November 14, 1947 when the debtor was in possession as a claim entitled to a first priority.

On appeal the 2nd Circuit affirmed. There was a dissent by Judge Clark objecting to the apportionment. He viewed the taxing statute (I.R.S. Sec. 1600-1611) as assessing a single unit tax on the employer for each calendar year of 3% on total wages paid by him during the calendar year.

In March 1957 the rolling ball to which I referred earlier took a peculiar turn of direction. The 9th Circuit in *Matter of Blackwood* (*supra*) applied the decision of *U. S.* v. *Fogarty* to a claim by the State of California for state unemployment taxes. The impact of this decision is that the rule of the Fogarty case is expanding.

Briefly stated, the trustee after paying allowed expenses of administration, paid the balance of moneys in his hands to priority wage claimants on a percentage pro-rata dividend. In doing so he deducted state and federal taxes assessed against the employees. The State of California having filed a claim for state unemployment taxes which are assessed against the employer, claimed the right to payment out of such wage dividends as well. The District Court supported the claim in California using *U. S.* v. *Fogarty* and *U. S.* v. *Curtis* as authority. On appeal the 9th Circuit affirmed. In doing so it went beyond the cases of Fogarty and Curtis by pointing out that under the California Code "wages" are defined as "all remuneration

payable for personal services, whether by private agreement or consent or by force of statute"; so that when a dividend on wage claims is paid out, it is done "by force of statute". Concluding with the proposition that sums paid as wage claim dividends are "wage" payments within the meaning of the California Code, and are subject to deduction for state unemployment taxes. Moreover, when deducted, such taxes are payable as a first priority expense under Section 64 of the Bankruptcy Act!

That is where the cases stand today. There will be more. My own Circuit, the 3rd, hasn't been asked to pass upon this question; neither has the 2nd Circuit so far as I know. But the same question is being encountered in every Circuit at the Bankruptcy Court level. The situation is one of nuisance to put it bluntly. Seldom is there any substantial tax sum involved. In the Fogarty case the sum involved was $1,491.34; in the Blackwood case it was $28.38. In the other cases the amount is undisclosed. It is safe to assume, however, that the amount of tax money collected from Bankrupt estates unde . e rule of the Fogarty case is small indeed. It is not worth all the trouble and expense it entails for Bankrupt estates.

Receivers and Trustees are usually persons who have no training in payroll accounting details. They usually need help in such matters and accounting services are expensive. Such expense as is entailed is borne by creditors in lower classifications, usually the lowly general creditors, whose burdens and fortunes are poor enough. In the end the result is difficult to justify. In some instances the payment is even circuitous by reason of tax refunds.

The Fogarty case is bad law. It is bad not only in its logical foundations but also in its practical applications. It produces a distortion in the bankruptcy function of distribution. In its practical effects it makes the Bankruptcy Court a virtual adjunct of the Bureau of Internal Revenue. In every sense of the word the Fogarty case

makes the Court a collector of taxes not only for the United States but for the States as well when the tax is one assessed on payroll. All of these factors suggest its faulty character.

It is fairly certain that Congress never considered or remotely intended that Courts of Bankruptcy should have withholding obligations on wage claim distributions; or that such distributions would be considered "wages"; or that the trustee in a bankruptcy liquidation was an "employer"—in any sense of that term.

The greatest iniquity which the rule of the Fogarty case accomplishes is that of allowing the government with a payroll tax claim to escalate and boot-strap its way from a fourth to a first priority under this doctrine. The overall effect is to partially nullify Section 64(a) of the Bankruptcy Act. This is its chief evil.

As far back as October 1951 our brother Referee Samuel C. Duberstein of New York in submitting the report of this Associations Committee on Improvements of the Bankruptcy Law, recommended the need for legislation to remove the burden of making and paying withholding and social security deductions on dividends paid on claims filed for pre-bankruptcy wages which the Fogarty and Curtis cases then imposed. I plead for action again, because it produces disorder in our scheme of distribution.

Orderliness is a great virtue. It is applicable to things in nature as well as to ideas. It is an essential quality in any system of thought. It is also a quality to be achieved in a system of jurisprudence. Orderliness implies harmony and things and ideas that are in harmonious relation are pleasant to look upon; those which are not have a quality of dissonance and we tend to shun and avoid them. The Fogarty case strikes a discordant note in our field of the law, it is out of harmony with sound bankruptcy law. Let us rid ourselves of it!

Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 728

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

On the following papers:

Notice of Motion, dated November 5, 1969, and supporting Application of William Otte, Trustee in Bankruptcy of Freedomland, Inc., by his attorney, Martin J. Caine, dated November 5, 1969, with proof of service upon Respondents; Answer of Respondent, United States, dated March 11, 1970, Answer of Respondent, City of New York, dated November 14, 1969,

and Respondent State of New York having been served with a copy of the Trustee's Notice of Motion and supporting Application but having defaulted in appearing and pleading to the Trustee's application, and the matter having come on to be heard on September 8, 1970, and after hearing the Trustee, William Otte, by his attorney, Martin J. Caine, by Howard Karasik, of counsel, in favor of the application, and Respondents United States and City of New York, by their respective attorneys, Honorable Whitney North Seymour, Jr., United States Attorney for the Southern District of New York, by Susan Freiman, of

Order

counsel, and Honorable J. Lee Rankin, Corporation Counsel, City of New York, by Raymond Herzog, of counsel, in opposition, and after filing the decision herein dated January 27, 1971, it is, on motion of Martin J. Caine, attorney for the Trustee

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., is authorized and directed upon the declaration of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims in this proceeding, to distribute to such claimants the full amount of their respective claims as filed and allowed, without withholding or deduction of United States, New York State, or New York City income, payroll, social security or other taxes of any nature, type or description, and it is further

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., is *not* required under law:

a. to withhold or deduct from any distribution of a dividend to class (2) priority wage claimants and/or to non-priority wage claimants in this proceeding any income, withholding, social security, or any other payroll taxes claimed by the United States, the State of New York, or the City of New York;

b. to pay to the United States, the State of New York, or the City of New York, any amounts whatever in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims in this proceeding, other than such amounts as are set forth in a class (1) administration expense claim or a class (4) priority tax claim filed and allowed in this proceeding;

Order

c. to file any report or tax return with the taxing authorities of the United States, the State of New York, or the City of New York, in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims.

d. to prepare or distribute to class (2) priority wage claimants and/or to non-priority wage claimants, or to file with the taxing authorities of the United States, the State of New York, or the City of New York, wage and tax statements (forms W-2) in connection with the distribution of a dividend upon class (2) priority wage claims and/or upon non-priority wage claims;

and it is further

ORDERED, that William Otte, Trustee in Bankruptcy of Freedomland, Inc., and individually, shall have no liability whatsoever to the United States, the State of New York, or the City of New York, by reason of any alleged failure to perform any of the functions set forth in subparagraphs (a), (b), (c) and (d) of the second decretal paragraph of this order, or by reason of his compliance with the terms of this order.

New York, New York
February 26, 1971

/s/ EDWARD J. RYAN
Referee in Bankruptcy

Affidavit of Service

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

State of New York
County of New York ss.:

LINDA LABATO, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 110 Rellim Drive, Old Bridge, New Jersey. That on the 2nd day of March, 1971, deponent served the within Order upon the following:

HONORABLE WHITNEY NORTH SEYMOUR, JR.
United States Attorney for the
Southern District of New York
U.S. Courthouse
Foley Square
New York, New York
Att: Miss Susan Freiman
Assistant U.S. Attorney

Affidavit of Service

HONORABLE J. LEE RANKIN
Corporation Counsel of the
City of New York
Municipal Building
New York, New York
Att: Robert Herzog, Esq.
Assistant Corporation Counsel

HONORABLE LOUIS J. LEFKOWITZ
Attorney General of the
State of New York
80 Centre Street
New York, New York

by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in an official depository under the exclusive care and custody of the U.S. Post Office Department within the State of New York.

LINDA LABATO

Sworn to before me
March , 1971

Transcript of Testimony, Dated January 20, 1972

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Before: HON. CONSTANCE BAKER MOTLEY,
District Judge.

New York, N. Y.,
January 20, 1972.

APPEARANCES:

WHITNEY NORTH SEYMOUR, JR., Esq.,
United States Attorney,
For the Government;

SUSAN FREIMAN, Esq.,
Assistant United States
Attorney, of counsel.

J. LEE RANKIN, Esq.,
Corporation Counsel, City of New York;
RAYMOND HERZOG, Esq.,
Assistant Corporation Counsel, of counsel.

WILLIAM OTTE, Esq., Trustee;
HOWARD KARASIK, Esq.,
Attorney for Trustee.

DAVID SHANDALOW, Esq.,
Attorney for Bankruptcy Lawyers Bar
Association, amicus curiae.

• • • • •

(86) • • •

ROBERT A. WIENER, called as a witness by the Trustee, being first duly sworn, testified as follows:

Direct Examination by Mr. Karasik:

Q. Mr. Wiener, are you an accountant? A. I am.

Q. Are you a certified public accountant? A. I am.

Q. Were you retained pursuant to court order by the trustee in bankruptcy? A. I was.

Q. Is there any area of specialization in accountancy that you specialize in? A. I have specialized in insolvency accounting since 1949.

Q. Do you know where the bankrupt's records are located? A. At Underwriters' Salvage.

(87)

Mr. Karasik: Your Honor, the trustee's report filed in this proceeding indicates that there are forty-two filing cabinets filled with records. I ask the Court to take judicial notice of the fact that such is the trustee's report.

The Court: Wait a minute. The trustee——

Mr. Karasik: Has filed a report. It is incumbent upon the trustee in a bankruptcy proceeding pursuant to the rules of the court to file a report with the court advising the court of the records that the trustee has taken into his possession.

There is on file the trustee's report indicating that there are forty-two filing cabinets filled with records of the bankrupt located at Underwriters' Salvage Company. This has a bearing, your Honor—

The Court: What do those records relate to?

Mr. Karasik: Well, these records relate to all of the business activities of the bankrupt.

Miss Freiman: Your Honor, may I interpose an objection. Even if the trustee's report were properly

received the existence of forty-two filing cabinets filled with records of the bankrupt, I do not feel has any relevance to the question before the Court today.

The Court: Yes, I don't see the relevancy of it.

(88)

Mr. Karasik: The relevancy is—it goes to the question of the burden and the ability of the accountant to ascertain the exact amount of taxes that would have to be deducted in the event the Government were to prevail in its position.

It also goes to the problem of ascertaining the social security numbers of the various employees who have filed claims in this proceeding, assuming, of course, that the Government were to prevail.

Miss Freiman: Your Honor, I fail to see how the bankrupt's records would have anything to do with the tax due on a $600 payment made years after the bankrupt has gone out of business.

Mr. Karasik: The records relate, among other things, to ascertaining social security numbers, which, as will be shown, are very important to the recipients of wage claim payments.

The Court: Well, are you suggesting that the fact there are forty-two filing cabinets in the last five or six years that this matter has been pending that the trustee has not gone through those records to see what is contained therein?

Mr. Karasik: The trustee—when it becomes necessary for particular purposes the trustee will go through (89) certain records. It is in terms of the economy of the administration of the bankruptcy proceeding that the trustee avoids going through the records because it is unnecessary.

Now, in this particular case there may never be a distribution to general unsecured creditors, and therefore it is unnecessary at this point to go through

the bankrupt's books and records to evaluate the propriety or correctness of claims by the unsecured creditors. But if the trustee or his accountant has to go back to look through records to ascertain, among other things, social security numbers or exemptions or things of that nature, then of course it would become extremely burdensome to come up with a correct record of monies that would have to be paid out to individual wage claimants.

Mr. Herzog: Well, your Honor, I'm going to object to this.

The Court: Yes. That assumes that the forty-two filing cabinets are just a hodge-podge and nobody knows anything about them. That would have to be your basic assumption, that here we have forty-two files which have never been properly filed and entirely mixed up and confused so that nobody can work with these files.

Mr. Karasik: I am not prepared to offer testimony as to that, even though this is my belief.

(90)

By Mr. Karasik:

Q. Let's go to the heart of the matter, Mr. Wiener. What steps would you have to take to ascertain the exact amount of the United States, New York State and New York City taxes that would have to be withheld in connection with a wage claim distribution to employees or former employees of the bankrupt if the Court determines that such withholding should be made? A. I would have to determine the social security number of each wage earner. I would try to determine the possible exemptions by direct communication with each wage earner based on the address shown on the claim.

I would then, after determining the exemptions, deter-

mine the amount of taxes that should be deducted on the wage payment for Federal, State and City.

I would have to prepare a detailed schedule for reconciliation purpose showing the name, the social security number, the total wage claim as allowed, the amount of Federal tax withheld, the amount of social security tax withheld, the amount of New York State tax withheld, the amount of New York City tax withheld.

I would have to summarize that and cross-reference it. The information, after being summarized, cross-referenced and cross-footed, would be transposed initially to the (91) Form 941.

The Court: What do you mean by cross-referenced?

The Witness: Back to the claim filed in the proceeding, and make sure of the accuracy of the schedule.

The Court: All right, go ahead.

A. (Continuing) the information contained in this schedule would then be transposed to the Form 941, with the social security number, the name, the amount of the wage. A computation would then be made at the top of the 941 determining the amount of social security taxes, and then the balance inserted for withholding taxes.

Then the W-2 forms would have to be prepared, in which would be inserted the name of the employer, care of the trustee in bankruptcy at the trustee's address, with the identification number as indicated by the previous witness. And all of the items indicating the Federal income tax withheld, the wages paid subject to withholding, the social security withheld, the total social security wages, the information as to whether the taxpayer was single or married as obtained by communicating with the taxpayer, the name of the state, the city, the state form number, the city form

number, the state income tax withheld, and the city income tax withheld.

After all of these forms were typed or written out, (92) an adding machine tape would have to be taken of all of the withholding tax set forth in the various categories, as well as the social security taxes, and that would then have to be compared with both the schedule previously referred to and also the Form 941.

Thereafter the various forms would have to be separated. The annual reconciliation forms would have to be secured from the various taxing agencies. The taxing agency forms which were required for each agency would be separated and forwarded to the taxing agency, together with the remittance and the reconciliation form, and then the form to the employees would be forwarded to them, and the retained copies kept for the trustee's file.

Checks, of course, would have to be made out to each employee.

Q. That is with regard to priority wage claims. Suppose there was a sufficient amount of money in the estate to also make payments for non-priority wage claims, would the same procedure have to be followed again? A. A separate list would have to be prepared, computing a dividend as to the amount of the allowable non-priority wage claims, a separate computation made, and then the two schedules would then have to be combined in order to prepare, on a third schedule, in order to prepare both the W-2 forms (93) and the Form 941.

Q. If a man earned $150 a week and had two exemptions would a flat deduction of 25% for Federal withholding tax purposes be more than the amount that would be withheld if the ordinary tax schedules were used? A. Yes, sir.

Miss Freiman: Objection. Your Honor, the Internal Revenue tables speak for themselves, and in any event, I do not believe that Mr. Wiener is in a

position where he can speak for the Internal Revenue Service as to what the correct amount of withholding is.

Mr. Karasik: Mr. Wiener is an accountant.

The Court: He is asking him to assume that 25% is withheld and asking him whether that would be more than——

Mr. Karasik: If a man earned $150 per week and had two exemptions——

The Court: Yes, I understand.

Mr. Karasik: —whether a 25% deduction——

The Court: Overruled.

A. The deduction for withholding tax under those circumstances, Federal withholding tax, would be $21.40, and then there would be a deduction of between seven and eight dollars—that's 5.2% of $150—that would be a total of twenty-seven or twenty-eight dollars, as compared to 25% of (94) the $150 which would be $37.50, a difference of a little less than $10.

Q. If a priority wage claim were made without deductions to a wage claimant in a bankruptcy proceeding, and on the assumption that the taxable income for that recipient was the same, would the recipient have to report the receipt of payment on his income tax return? A. Yes.

Q. And would he have to pay the tax to the United States Government? A. Yes.

Q. Now, if the trustee were required to withhold taxes in making a priority wage claim distribution, would the trustee be subject to inquiries from the recipients of the wage claimants as to why the deductions were made? In your experience, has this been done? A. It happens frequently.

Q. And the accountant also? A. The accountant always gets the inquiry.

Q. If a wage claim payment was made to an individual and a W-2 form prepared without a social security number indicated on the W-2 form, would the recipient of the wage claim payment be credited with the appropriate social security deduction withheld by the employer?

(95)

Miss Freiman: Objection, your Honor. I do not believe Mr. Wiener can testify to what the Social Security Administration would do.

A. With all due respect, the question is improperly phrased anyway. The credit is not from the W-2 forms, it's from the 941's.

Q. All right, then from the 941, if there is no social security number indicated on the form 941, would the recipient of a wage claim distribution be given credit for social security purposes?

Miss Freiman: Your Honor, again I object. Mr. Wiener is being asked to speculate—

Mr. Karasik: He is not being asked to speculate; the man is a Certified Public Accountant and I am asking him to testify from his experience as an accountant as to what the law is.

Miss Freiman: He is asking, your Honor, that Mr. Wiener tell us what he thinks Social Security would do.

The Court: Isn't that what you are asking him?

Mr. Karasik: I am not asking him—

Q. I'd like to know, Mr. Wiener, what does, in fact, Social Security do?

The Court: How does he know that? What is that based on?

(96)

The Witness: I can tell you, your Honor. If a 941 is filed without a social security number, marked unknown, shortly thereafter the filor, in this case the trustee in bankruptcy, receives a little card, an IBM card, from the Social Security Administration, advising the trustee, and this would apply to any employer, that since the number is unknown credit cannot be given and asking that the trustee or any other employer can furnish such number, and usually they send at least two requests.

Q. And again I ask the question: are you familiar with the Social Security procedure as to whether or not an individual receives credit where social security payments have been withheld but on this 941 no social security number is indicated? A. I am.

Q. And what is the practice? A. The individual does not get credit.

Q. If an individual wage claimant was receiving distribution of a wage claim, and if that wage claim were considered wages, and if that individual was receiving unemployment insurance coverage, what effect would the receipt of the wage claim distribution have on the individual's unemployment insurance coverage? A. It would terminate his unemployment insurance.

(97)

Q. If an individual is 65 years of age and is receiving social security benefits, what is the maximum amount of money he can receive and still be eligible for social security?

Miss Freiman: Your Honor, I believe I stated at the outset the Government's position that all of this is irrelevant, and I would appreciate being given a continuing objection to what might happen in

individual cases rather than interrupt repeatedly as Mr. Karasik is questioning.

The Court: Well, with respect to Mr. Karasik's claim that the Court ought to, in effect, disagree with the Sixth Circuit in Fogarty and find that this is not a wage payment, I suppose it may be relevant to that, as a matter of policy concerning a wage claim. So I will let him answer the question.

Miss Freiman: Your Honor, for the record, may I also state that my objection is also on the ground that I believe that Mr. Karasik may be offering it to show that the 25% which has been administratively fixed is arbitrary and capricious and unreasonable, and I also object to the introduction of the evidence on that ground.

Mr. Karasik: I hadn't thought of it but it is a good reason for introducing it.

The Court: All right, proceed.

(98)
A. What is the question?

(Record read.)

A. It used to be $1,200 and I believe they have increased it to either fourteen or fifteen hundred. I'm really not sure of the exact amount.

Q. Of earned income? A. That's right.

Q. Now, if a wage claim distribution were considered wages, and the wage claim recipient actually received that money, what effect would the receipt of that money have on the individual who had earned the maximum amount of money during the course of the year and who was also eligible for social security benefits? A. It would affect the amount of the benefits; it would reduce his benefits.

Cross-examination by Miss Freiman:

Q. Mr. Wiener, you gave us a long, and if I may compliment you, eloquent description of what would be done to prepare the W-2 forms and the 941's. Are you also familiar with the functions performed by a trustee's accountant in checking proofs of claim? A. Yes, I am.

(99)

Q. Would you please tell us what you have to do in order to check a proof of claim? A. In sum, to make comparisons between the proofs of claim and the books and records of the bankrupt.

Q. What more has to be done in order to either withhold and to prepare the return? A. We're not talking about the same taxes, are we, Miss Freiman?

Q. Well, if I may explain a little bit: When a trustee is obligated to check proofs of claim, is it customarily done by the trustee or by his accountant? A. By his accountant.

Q. Well, when you check the proofs of claim, you make certain comparisons to determine whether the claim is correct or not correct; is that right? A. Yes, that is right.

Q. And you described to us what you do when you withhold upon making a distribution to the wage claimant. A. Yes.

Q. How much more work is imposed on you by the requirement to withhold and to pay the Government? A. You're talking about two different things, Miss Freiman.

The Court: Well, tell us first what you do with (100) respect to an ordinary claim from a creditor; what do you do in checking that claim?

The Witness: Initially, we compare the claims to the schedules filed in the bankruptcy proceeding. If the claim agrees with the schedules filed in the bankruptcy proceeding, we recommend its acceptance. If it does not agree, then we go back to the bank-

rupt's books and records and make a comparison to the statement which is frequently attached to the claim and try to prepare a reconciliation. If we find that the variance is substantial and that there are sufficient assets in the case to make it important to object to the claim, we recommend to the trustee that he bring on objections and formal hearings before the referee in bankruptcy.

The Court: In this case were the wage claims scheduled?

The Witness: The wage claims would also be checked back to the books and records of the bankrupt.

The Court: My question was, in this case, were these wage claims scheduled?

The Witness: I would have to make a comparison. I believe that they were scheduled—I haven't looked at the schedules recently, but my recollection is that they were scheduled.

The Court: Well, what do we have to do to find
(101) out whether they were or weren't?

The Witness: Mr. Karasik has some schedules in court, I believe.

Mr. Karasik: I have some scehdules here, your Honor.

The Witness: May I see the schedules you have with you? I believe there is an indication on those schedules as to whether or not they were scheduled.

(Document is handed to the witness.)

The Witness: Yes, I believe that they were scheduled, your Honor.

The Court: Are you looking at a document which shows that they were scheduled?

The Witness: The document states, "Amount due as per bankrupt's books," and I am reasonably certain that indicates they were scheduled.

The Court: All right.

Mr. Karasik: Your Honor, the schedules are a matter of public record in this court.

The Court: I don't have the so-called public records before me.

Mr. Karasik: This hasn't been an issue, otherwise I would have brought out a complete set of schedules, had I known.

(102)

The Court: Well, we could always find out, if we can, but I think it is important to know in this case whether these wage claims were scheduled.

By Miss Freiman:

Q. Mr. Wiener, do you yourself prepare W-2 forms for trustees? A. No, ma'am.

Q. Who in your office does prepare them? A. One of the junior accountants.

Q. What is there about his training which is required for him to prepare these returns? A. Familiarity with payroll records, and the Internal Revenue Code and regulations.

Q. Why does he need to know the code and regulations? A. For the proper preparation of these forms.

Q. Now, if the Internal Revenue Service just requires a flat 25% withhled of which 5.2% is for FICA and the balance is for income tax, is his training required for that? A. No.

Q. Mr. Wiener, who determines how much gets paid to general creditors in the event the estate is large enough? A. The trustee or his counsel makes that calculation, and on occasion we do the calculation depending on the size of the estate.

(103)

Q. If there is an estate of $5,000 and they only spend $900 from five, and the amounts of the claims vary from

$30 to $100,000, how is it determined how much paid to each particular creditor? A. By a mathematical computation made after the referee in bankruptcy has determined the expenses of administration, the remaining assets for payment of priorities under the Bankruptcy Act, and then the portion of the money remaining to unsecured creditors.

Q. Could you explain to us the manner in which this mathematical computation is done, the formula which is followed? A. In the first instance, there would be a determination of the gross amount of the estate, the amount of cash remaining on hand in the possession of the trustee. Then an examination would be made of the referee's report of allowances and the expense of administration.

We would then deduct the amount from the assets in the estate, and assuming your $5,000 in the estate, less, let's say, $1,000, and there was $500,000 in claims, you would make a mathematical computation, theoretically spreading the $1,000 over the $5,000 by using a calculator or some other adding machine.

Q. In other words, you would have to add up the total (104) amount of all of the claims and then for a $30 claim, the particular creditor would get thirty over the $500,000 in claims? A. Theoretically, yes.

Q. Have you ever heard of a trustee requesting the bankruptcy court for leave not to make those payments because the computations are difficult? A. I don't know; I don't remember.

Q. Do you have a copy of the social security IBM card with you? A. No, I do not.

Miss Freiman: You Honor, I move to strike all of the testimony about that IBM card because I have not had an opportunity to study it and cross-examine on it.

Mr. Karasik: Your Honor—

The Court: Just a moment. What social security IBM card is that?

Miss Freiman: Mr. Wiener has testified that social security never gives credit when there is no social security number given for an employee, and he based on an IBM card that he talked about. He does not have the IBM card here, and I therefore do not have an opportunity to examine it and cross-examine about it.

The Court: He based that on an IBM card?

(105)

Mr. Karasik: He based it on his knowledge as an accountant with expertise in insolvency matters, and no IBM card was introduced in evidence.

The Court: Well, the problem can be resolved by calling somebody from the Social Security Administration.

Miss Freiman: Well, your Honor, I would like to call Miss Pillinger again. She is familiar with that aspect of the problem.

The Court: Wait a minute. I said somebody from the Social Security Administration. We have an office here in New York, don't we? Can't we resolve this question by calling somebody from there?

Miss Freiman: I could try, your Honor, if we could continue this case until tomorrow, but I believe that Miss Pillinger is familiar enough with this so that she could testify to what happens when a social security number is not given.

The Court: She did it before when she was on the stand, didn't she?

Miss Freiman: In any event, I do press my objection to Mr. Wiener's testimony about the social security because it does not give particulars.

The Court: Well, I think the way to resolve it is to call somebody from the Social Security Adminis-

tration (106) and tell us what does happen when a number is not furnished. It would be very simple for somebody to walk over here from the Social Security office. So we will take that tomorrow.

Is there anything more that you have of this witness?

Miss Freiman: No, your Honor.

The Witness: Thank you very much, your Honor, for permitting me to testify today.

The Court: I think in this connection the trustee's counsel should get out from the records a copy of the scheduling of these claims, so that we could clarify that point, as to whether or not they were scheduled also.

Mr. Karasik: As the Court is aware, the fact that something is scheduled does not mean that the trustee in bankruptcy is bound by what is scheduled. As a matter of practice, it frequently occurs that accountants for trustees will go behind the scheduled amounts, to the books and records, and the trustee is not bound by what is scheduled, because if he were——

The Court: That may very well be, but I want to know what the facts are in this case. This is the way the matter was conducted before the referee, nobody really pinned down any particular facts. Isn't that the problem we have here? There were a lot of things suggested, but nobody really said what the facts were.

Mr. Karasik: I could arrange to have——

The Court: You say this was burdensome, and that was based on no evidence. That's what I am trying to get at. You also said there was a rule here, a 25% rule, which nobody attempted to explain the origin of, and that is why we have to have a further hearing here.

What we ought to do now is to try to complete the record here with respect to the facts. If these things were scheduled, they were scheduled. If they were not scheduled, they were not scheduled. We are only asking to know whether they were in fact or not. We don't need any argument as to what is liable to happen at some time to the scheduling. All we want are the facts.

I want to know whether they were scheduled, and how much each employee claimed, in any event, and copies of the proofs of claim; that is, what was sent in by the employees. We can then see whether any of those claims contain a social security number.

What we will do then is to recess until noon tomorrow so that you can have a chance to get those records out.

Mr. Karasik: Thank you.

(Adjourned to January 21, 1972 at 12:00 noon.)

Opinion On Petition To Review

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

64 B 727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

APPEARANCES:

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Opinion On Petition To Review

CONSTANCE BAKER MOTLEY, *DJ.*

Freedomland, Inc. filed a petition for an arrangement under Chapter 11 of the Bankruptcy Act on September 15, 1964. The arrangement proceeding failed and on August 30, 1965 the debtor was adjudicated a bankrupt. Thereafter, on November 7, 1969 the trustee, William Otte, moved before the referee for an order authorizing him to pay 413 priority wage claimants without withholding therefrom United States, New York State, or New York City income taxes, federal social security taxes, or any other payroll taxes. This relief was granted.

The Bankruptcy Act, Section 64(a), 11 U.S.C. § 104, establishes five categories of claims, in descending order, which are entitled to payment before the general creditors of the bankrupt are paid. The payment of claims for wages earned within the three month period preceding bankruptcy, in amounts not exceeding $600, falls within the second category of priorities. Claims for taxes which "became legally due and owing" by the bankrupt to any governmental body are entitled to a fourth priority.

The trustee was also granted an order specifically declaring that he was not required to: 1) pay to any governmental body any amounts whatsoever in connection with such wage claim distributions; 2) prepare and distribute to the wage claimants employee wage and tax statements and file copies thereof with tax authorities; 3) prepare and file with tax authorities employer wage and tax withholding statements; 4) pay any penalties for failure to withhold and pay or file returns.

The United States, the State of New York, and the City of New York had been given notice of the trustee's application for such a declaration and order, although none had filed a proof of claim for income taxes due on these

wages.[1] The 413 wage claimants had filed their proofs of claim within the six month period following the initiation of bankruptcy proceedings on September 15, 1964 as provided by the Bankruptcy Act. 11 U.S.C. § 93. The total of these wages ($80,000) had been scheduled by the bankrupt upon the filing of his September 14, 1965 petition for an arrangement.

The State of New York failed to respond. The City of New York responded claiming that the trustee is required to withhold from any wage claims paid by him New York City income taxes and to report and pay same to the City, although the New York City income tax law was not in existence in 1964—the time when the wages were earned by the employees. The United States responded claiming that the trustee is liable to: 1) withhold income and social security taxes;[2] 2) pay such taxes to the United States;[3] 3) file the necessary returns (forms W-2 and 941);[4] 4) furnish each employee with form W-2;[5] and 5) pay any penalty assessed for failure to withhold, pay and file the returns.[6]

Succinctly stated, the trustee's position in support of his application was as follows:

1) Since 413 priority wage claims have been filed in this proceeding, none of which exceeds $600.00, compliance

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[1] The United States had filed a claim, Claim No. 441, on February 9, 1965 seeking payment of $82,565.14 for federal income and social security taxes due on those wages actually paid during the third quarter of 1964. The 413 claims here relate to the unpaid wages during this period. This was the quarter immediately preceding any bankruptcy proceeding. The City of New York had filed claims for other city taxes such as amusement taxes.

[2] 26 U.S.C. §§ 3402(a), 3102(a).

[3] 26 U.S.C. §§ 3402(d), 3102(b), 3403, 6672, 7201.

[4] 26 U.S.C. §§ 6011(a), 6041(a), 7203.

[5] 26 U.S.C. §§ 6051(a), 7204.

[6] 26 U.S.C. § 6674.

with federal, state and city tax provisions would be onerous because of the administrative, accounting, and legal costs involved, and the unavailability of relevant information. Public policy, administrative convenience, the scheme of the Bankruptcy Act, and the policy underpinning withholding taxes dictate that the trustee in bankruptcy not be required to withhold taxes and file returns in connection with payments to wage claimants.

2) Making an automatic 25% federal tax deduction (which is the present practice in this District) and a 1% city deduction, in lieu of making an exact calculation of the taxes due from each employee pursuant to progressive tax tables and currently claimed exemptions would constitute a substantial tax over-payment for each employee and therefore would be unconstitutional.

3) A class 2 priority wage claim payment made pursuant to the Bankruptcy Act, § 64a(2), does not constitute wages for the purposes of the withholding and reporting provisions of the Internal Revenue Code;

4) New York City is not entitled to have income taxes for its benefit withheld since, if the wages had actually been paid when due, nothing would have been due the city.

In response to the trustee's claims the United States took the following positions:

1) The bankruptcy court is without power to consider the trustee's application on the ground that a declaratory judgment and injunction with respect to taxes is specifically prohibited. The trustee's remedy is to pay the tax for 1 wage claimant and sue for a refund. Under the doctrine of primary jurisdiction the bankruptcy court should at least refrain from acting until the Internal Revenue Service, the administrative agency to which has been given the authority to interpret and apply the statute, has acted.

2) Assuming the court does have jurisdiction, the Internal Revenue Code requires the trustee to withhold, report and pay income and social security taxes.

3) The 25% flat rate rule prevailing in this District is reasonable in view of the fact that, as the trustee argues, it may often be difficult to determine the correct rate for each employee.

From the adverse decision and order of the referee, the United States and the City of New York filed the instant petition for review.

The referee ruled that the bankruptcy court had jurisdiction of the application made by the trustee for instructions with respect to the proposed distribution to wage claimants, and that the Government's contention with regard to lack of jurisdiction was without merit. This court agrees. The bankruptcy court clearly had jurisdiction to adjudicate the tax claims now made by petitioners in response to the trustee's application for an order. The United States and the City both claim that the taxes in issue are costs and expenses of administration and are therefore entitled to a first priority under § 64(a) of the Bankruptcy Act. 11 U.S.C. § 11 (2) and (2A). See *United States* v. *Randal,* 401 U.S. 513 (1971) and *Nicholas* v. *United States,* 384 U.S. 678 (1966), and cases cited *infra* where the bankruptcy court's jurisdiction over similar claims was apparently unchallenged.

The gist of the controversy, as the referee saw it, is whether a trustee in bankruptcy is an "employer" who is paying "wages" when he makes a distribution to wage claimants who are entitled to priority in distribution of estate assets by virtue of the Bankruptcy Act, so that as such "employer" the trustee is required to comply with the applicable withholding and reporting provisions of federal, state, and city tax laws.

The referee reviewed this question as requiring a decision with respect to "which of two clearly desirable, but countervailing objectives is to be preferred, viz., the collection of taxes or the efficient administration of the estate in bankruptcy." [7] Viewing the issue in this fashion, the referee preferred the Bankruptcy Act on the ground that "compliance with withholding and reporting requirements of tax authorities is utterly inconsistent with the spirit and letter of the Bankruptcy Act." [8] He found that compliance with taxing requirements imposes a further burden on the administration of bankrupt estates which is entirely inconsistent with the objective of efficient, expeditious, economic administration of bankrupt estates.[9] He accordingly held "that a trustee in bankruptcy is not an employer who pays wages when he distributes dividends on account of wage claims whether priority or general." [10]

In so holding, the referee expressly rejected the holding to the contrary in the twenty-five year old precedent, *United States* v. *Fogarty,* 164 F.2d 26 (8th Cir. 1947), followed in *United States* v. *Curtis,* 178 F.2d 268 (6th Cir. 1949), *cert. den.,* 339 U.S. 965 (1950); *In re Daigle,* 111 F. Supp. 109 (D.C. Me. 1953); *Lines* v. *State of California,* 242 F.2d 201 (9th Cir. 1957), *cert. den.,* 355 U.S. 857; *In re Connecticut Motor Lines, Inc.,* 336 F.2d 96 (3rd Cir. 1964). In the *Fogarty* case the Eighth Circuit ruled that the payment of wage claims are "wages" within the meaning of applicable federal tax provisions and that the trustee as the person in "control of the payment" of such wages has the duty under the Internal Revenue Code to withhold and pay income and social security taxes thereon. And it appears that no court has yet ruled contrary to the *Fogarty* court

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[7] Referees' Opinion, pp. 7-8.
[8] *Id.* p. 12.
[9] *Id.* p. 10.
[10] *Id.* p. 12.

on the issue of the duty and liability of the trustee to withhold and pay such taxes. The *Fogarty* court viewed the need to protect the future social security benefits of wage earners, which are based solely on wages earned, as of paramount importance in the distribution of wage claims. The able referee, correctly, was of the view that, since this precise question of the liability of a trustee in bankruptcy to withhold and pay has not been passed upon by the Court of Appeals for this Circuit (or the United States Supreme Court), he was free to hold to the contrary.

In rejecting the ruling in the *Fogarty* case, the referee concluded that the "basic vice of *Fogarty* was its consideration of the problem before it merely as a tax case without giving due regard to the consequences to orderly, efficient, economic bankruptcy administration which necessarily ensue from that ruling."[11] In deciding not to follow the Eighth Circuit, the referee relied completely on the criticism of the *Fogarty* case made by another referee, Russell L. Hiller of Pennsylvania, in a paper entitled "The Folly of the *Fogarty* case". The critique is attached to the referee's opinion. The Hiller paper was read at the Annual Conference of the National Association of Referees in Bankruptcy in Indianapolis in October 1956, about a decade after *Fogarty*. Referee Hiller stated at the time: "In practice, as any referee knows, the application of the *Fogarty* rule is sheer nonsense." Referee Ryan agreed. However, other than the one example given by Referee Hiller in his paper, there was no evidence in the record before Referee Ryan to support his conclusion.

Referee Hiller had cited a case before him in which it cost an estate $600 to have the bankrupt's former comptroller, who was familiar with the payroll, calculate the taxes and prepare a schedule of net payments due each wage claimant. In that case the gross payment to the

[11] *Id.* p. 10.

United States for withholding taxes was $1,611.41 and $1,761.72 for employment taxes. Since the amount of taxes due in that case was small compared to the cost, Referee Hiller concluded the *cost* of compliance with tax provisions to a bankrupt estate is unjustified. Despite the *Fogarty* decision and Referee Hiller's criticism, however, the Congress has not seen fit to relieve the trustee of whatever burden (whether financial or otherwise) compliance with tax provisions may impose on bankrupt estates.

This court, uncertain as to what burdens are in fact imposed, received further evidence with respect to the administrative burden and costs which would be imposed upon the trustee here in meeting federal and city taxing requirements.[12] The court felt that such further evidence was necessary not only in view of the fact that there was no evidence before Referee Ryan (other than the Hiller example) to support the referee's conclusion but apparently little in his experience also as a referee in this District to sustain the conclusion. Referee Ryan in his opinion said:

> "In practice, except in rare cases, no trustee in bankruptcy complies with state and city withholding and reporting requirements in the Southern District of New York at the present time. Again, except in rare instances, trustees in bankruptcy do not attempt to comply with federal reporting requirements. In effecting distribution to wage claimants, 25% of the gross wage claims being paid is deducted and transmitted by one check to the Director of Internal Revenue without attempting to allocate the proportion

[12] General Order 47. In *Nicholas* v. *United States*, 384 U.S. 478 (1966) the majority ruled that compliance by the debtor in possession with tax provisions requiring the filing of a return with respect to the income and social security taxes due there was not burdensome (at p. 695). The minority urged that the contrary may be true (at p. 700).

of such 'withholding tax' to the various wage claimants for appropriate credit. The origin of this practice was not explained in the instant proceedings. The record was barren of any evidence of what is the practice in other districts.[18]

The referee gave no reason for rejecting the 25% rule. In operation, the 25% rule covered both the income tax due from a wage claimant on the wage claim distribution and the claimant's social security tax contribution. For example: the wage claimant's present social security tax contribution rate is 5.2%. Under the 25% rule, 5.2% would be credited to the claimant's social security account and 19.8% would be credited toward his income tax for the year.

Further evidence received by the court on behalf of the United States shows that the trustee would be required to file what an employer is now required to file each quarter. This is a return known as form 941 on which the employer reports 1) total wages subject to withholding, 2) total amount of income tax withheld, 3) total of wages subject to social security taxes, 4) total security taxes, 5) each employee's social security number, 6) name of each employee, and 7) total of each employee's taxable social security wages (Government's Exh. B). The importance of this form is that it advises the Government of social security credits earned by an employee. The information on this form is sent to the Social Security Administration's main office in Baltimore, Maryland.

The employer is also required at the end of the year to file with the taxing authorities a form W-3 indicating the withheld income taxes for each quarter. In this case the trustee would file this form for the quarter in which the wage dividends are paid.

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[18] Referee's Opinion, p. 11.

An employer is also required at the end of each year to prepare and file for each employee an employee's wage and tax statement known as form W-2 and to give this form with required copies to the employee. The employee is required to attach same from each employer to his income tax return for the year in which wages payments are received. This form is familiar to every wage or salary earner. It requires the employer to give thereon the following information as to an employee: a) federal income tax withheld; b) wages paid subject to withholding in the year in question and any other compensation; c) state and city income tax withheld; d) social security tax withheld; e) total social security wages paid in the year in question; f) marital status of the employee; g) employee's social security number.

The Government also adduced evidence from which this court finds that the foregoing forms can be and usually are filled out by a payroll clerk, bookkeeper, or other clerical employee of the employer. The court also finds that, assuming the availability of an employer's payroll records showing each wage claimant's social security number, the preparation of such forms by employing the 25% rule would not be unduly time consuming or costly for the trustee's accountant to prepare in connection with verifying each wage claim before presentation to the referee for payment approval. The trustee's accountant testified that these forms would be prepared by a junior accountant in his office.

The trustee's accountant also testified that the calculation of the proper taxes and the preparation of the required forms would be difficult because the trustee must first ascertain the present number of exemptions to which an employee may be entitled and his present annual income. The trustee's accountant further testified that compliance with tax provisions is expensive and burdensome because the trustee does not have the staff to make the required calculations or prepare required forms.

The trustee, however, failed to prove that services of an accountant as opposed to a clerk are required either for making the necessary 25% tax calculations or for preparing the required forms. Further, the trustee failed to prove that the employer's payroll records were not available for the purpose of securing therefrom the social security numbers of the 413 wage claimants. Schedule A-1 attached to the bankrupt's petition for an arrangement clearly indicates that its payroll records for the 413 wage claimants are available. Proper social security numbers are necessary not only for income tax purposes but for the proper crediting of the employee's social security account. The evidence showed that in the event a form 941 is filed without social security numbers and the employer is unable to furnish them a search is made for the employees by the district office of IRS in which the employees reside.

In response to the trustee's claim that it would be essential to know a wage claimant's presently claimed exemptions in order to compute the tax, the Government's evidence established that the 413 wage claimants are to be treated as persons with a second job. This means that if exact calculations are desired in lieu of the 25% rule, these income tax calculations are to be made without reference to exemptions or marital status. 26 U.S.C. § 3402(m)(3)(B). The evidence was that a person with more than one job would claim exemptions only with the prime employer so that there would not be under-withholding of taxes at the end of the year. He would file a certificate claiming zero exemption with the second employer.

Moreover, the Government contends, and the trustee does not deny, that exact income tax calculations need not be made under present IRS policy. The IRS has long since accepted, as the referee noted, the single rate deduction of 25% to cover both income and social security taxes for each employee. If too much income or social security taxes are by this method withheld from an employee, he is, of course,

entitled to claim a refund for overpayment on his income tax return for the year when he receives his wage claim dividend. In order to secure these refunds, it is necessary for the employee to have a form W-2 showing such withheld income and social security taxes.

In the past whenever a trustee in bankruptcy sent to the IRS a check representing 25% of the gross wage claims paid by him, the IRS prepared the forms (Tr. p. 80). These forms were prepared by the Special Procedures Section which files the Government's proofs of claim in bankruptcy and handles all bankruptcy litigation. The Government now takes the position that these forms should be prepared by the trustees in bankruptcy.

With respect to the 25% flat rate rule the trustee simply argued that application of such rule would be unfair to the wage claimants because most claimants would have too much tax withheld and would then have the burden of applying for a refund.

Evidence received on behalf of the City of New York revealed that the trustee would be required to file with it two simple reporting forms (City's Exh. 1 and 2). The only information sought by the City's forms relates to income taxes withheld and amounts paid to the City during the year.

As a result of the further evidence adduced, this court finds that compliance with federal and city tax provisions by utilizing the existing 25% rule is not unduly burdensome or expensive. Compliance with such requirements adds only slightly to the trustee's inescapable task and cost of verifying each claim before payment. Consequently, failure of a trustee to comply with tax provisions cannot be predicated on the ground that compliance is so contrary to the objective of efficient expeditious and economic administration of bankruptcy that it ought not be required of trustees.

We now come to the legal issues. The first question is whether taxes are required to be withheld by the trustee

upon the payment of wage claims which accrued prior to any bankruptcy proceeding. In *United States* v. *Fogarty, supra*, the Eighth Circuit, in a well reasoned persuasive opinion with which this court agrees, ruled that the payment of such wage claims is the payment of wages within the meaning of the Internal Revenue Code and that the trustee, as the person controlling the payment of such wages, is required by that Code to withhold federal income and social security taxes. 26 U.S.C. § 3121(a), (b), 3401 (d). Although this Circuit has not passed directly on this question in a bankruptcy case, in *Educational Fund of the Electrical Industry* v. *United States*, 426 F.2d 1053 (2d Cir. 1970), it agreed with the latter holding of the Eighth Circuit in another context and held that the person having control of the payment of the wages in lieu of an employer is obligated to withhold federal income taxes.

The second question is whether the trustee is bound to prepare and file form 941 and prepare, file and distribute to each wage claimant form W-2. In *Nicholas* v. *United States*, 384 U.S. 678 (1966), the Court held that a superseding trustee in bankruptcy is liable for penalties assessed by federal taxing authorities for failure to file tax returns on income and social security taxes withheld but not paid by the debtor in possession during an arrangement proceeding under Chapter XI. [It expressly left open the question whether a trustee in bankruptcy must file returns for the bankrupt for taxes "incurred" before bankruptcy (at p. 692 fn. 27).] There the Court said: "It is conceded that the trustee, in his status as representative of the bankrupt estate and successor in interest to the debtor in possession, is liable for the principal of the taxes incurred by the debtor in possession, to the extent of the priority enjoyed by taxes under 64a(1) of the Bankruptcy Act. Once that liability is established, there can be no question that, under § 6011(a) of the Internal Revenue Code, the trustee was under an obligation to file returns for these taxes, even

though the taxes themselves were incurred by the debtor in possession during the pendency of the arrangement proceeding" (at pp. 692-693). Following that reasoning of *Nicholas* v. *United States, supra*, and the reasoning of *United States* v. *Fogarty, supra*, that the trustee steps into the shoes of the bankrupt as employer for the purposes of paying pre-bankruptcy wages and withholding income and social security taxes thereon, this court holds that the trustee has the duty to file forms 941 and W-2.

The third and most difficult question necessary for decision on this review is whether the payment of the withheld taxes is entitled to a first priority under Section 64 (a)(1) of the Bankruptcy Act as costs and expenses of administration as the Government claims. In support of its claim the Government relies upon the *Fogarty* case. There the Eighth Circuit held that the withheld taxes should be allowed and classified as an expense of administration. In reaching its conclusion, the court was impressed by the fact that the taxes were not payable at the time the petition was filed by the bankrupt since the wages had not been paid. It was persuaded that the taxes only accrued, in the language of the social security statute,[14] "as and when" the wages are paid, that is, on the actual payment there of the wage claims. The Court said, and this seemed controlling, that the wage payments were made "during the administration of the estate pursuant to the orders of the bankruptcy court" (at p. 33). In short, the taxes accrued after bankruptcy commenced and were therefore entitled to a first priority as an expense of administration.

The Sixth Circuit in *United States* v. *Curtis, supra*, although it agreed with the Eighth Circuit that the trustee must withhold the taxes on the payment of wages earned

[14] 26 U.S.C. § 3102.

prior to bankruptcy, did not reach the question whether the payment of the taxes is entitled to a first priority. It expressly did not base its decision on the Eighth Circuit's view of this question.

The Seventh Circuit in *In re John Horne Co.*, 220 F.2d 33 (1955), noted that it was not "impressed" with the reasoning of the Eighth Circuit in granting a first priority to the payment of taxes on unpaid pre-bankruptcy wages but found no necessity to follow or reject that holding. The facts before that court were distinguishable. In the Seventh Circuit case the wages had been paid before bankruptcy. The taxes withheld thereon were unpaid. The court consequently had no problem in finding that those taxes were "legally due and owing" to the United States at the time of the filing of the bankruptcy claim and as such were entitled only to a fourth priority status.

In *Pomper* v. *United States*, 196 F.2d 211 (2d Cir. 1952) this Circuit dealt with the annual federal unemployment tax on employers which was a 3% tax on wages paid during the year. In that case the tax became due for the year in question after commencement of a Chapter XI proceeding. Although the tax was not payable until after the Chapter XI proceeding had commenced, the court held the tax divisible. It ruled that the tax was entitled to a first priority with respect to payment only as to those wages paid by the debtor in possession. As to those wages actually paid before bankruptcy, the court held that payment of the tax was entitled to only a fourth priority, even though the bankrupt's estate was insufficient to pay fourth priority claims. In assigning a fourth priority to that portion of the tax relating to pre-bankruptcy wages, the court pointed out that the amount of the tax for any specific period is computable by simple arithmetic based on wages paid to that point. Then the court said: "The mere fact that the tax is not due until the year's end does not detract from the fact that it is incurred in a readily ascertainable amount as the wages are paid" (at p. 213). In short, although the tax was not payable to the Government until the end of a given year, the tax on wages paid before the end of the year were legally due and owing the United States because readily ascertainable.

The Ninth Circuit reached the same conclusion as the Eighth Circuit in *Lines* v. *State of California, supra,* with respect to payment by the trustee of that state's unemployment tax. The tax there had been imposed upon employers and was based upon the payment of wages earned within three months prior to bankruptcy but paid during bankruptcy.

The Third Circuit, however, parted company with the Eighth Circuit on the priority of payment issue in *In re Connecticut Motor Lines, Inc., supra,* and held that the withheld taxes are entitled only to a fourth priority. It had embraced, however, the Eighth Circuit's holding with respect to the duty and liability of the trustee to withhold taxes upon the payment of pre-bankruptcy wages (at p. 99, fn. 9).

This court is persuaded, as the Third Circuit was, that employee income and social security taxes withheld upon the payment of priority wage claims are not convincingly characterized as costs and expenses of administration but are more properly characterized as taxes "legally due and owing" the United States by the bankrupt, when attempting to fit them within the Section 64(a) scheme of priorities. These are neither taxes on activities involved in further developing or protecting the bankrupt's estate nor taxes imposed on the mere distribution of the wages, the chief characteristics of taxes denominated costs and expenses of administration.[15] These are taxes on wages for services performed for the bankrupt before the bankruptcy. They

[15] 40 N.Y.U. Law Rev. 360 (1965); 56 Mich. Law Rev. 631 (1958).

are not taxes imposed on any post bankruptcy activity. As the Third Circuit said, if the trustee can be cast in the role of bankrupt-employer for the purpose of the taxes attaching in the first place, as the Eighth Circuit ruled, it is difficult to see why he cannot also be bankrupt-employer for the purpose of determining by whom the taxes are owed for Section 64(a) purposes.

Section 64(a)(4) was amended after the Third Circuit case in 1966 to read that fourth priority shall be given to "taxes which *became* legally due and owing by the bankrupt" to any governmental body [Underlined portion added by amendment]. The Congress did not undertake to define the term "legally due and owing".[16] The question of what taxes "became legally due and owing" by the bankrupt was thus left to the courts. In *Matter of International Match Corp.*, 79 F.2d 203 (2d Cir. 1935), *cert. den. sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652, this Circuit had ruled that before a tax could be found to be legally due and owing by the bankrupt before bankruptcy enough must have been known about the basis of the tax to make the tax computable or "knowable" before bankruptcy, although not collectible until after adjudication. "The time of the accrual of the obligation to pay rather than the time when the obligation is to be discharged is the controlling feature" (at p. 205).

The taxes in question are a part of the wages due each employee. The obligation to pay those wages plainly accrued before bankruptcy. The fact that the wages are now to be paid after adjudication is, therefore, not controlling in determining when the tax obligation accrued. The tax obligation here accrued prior to bankruptcy along with the obligation to pay the wage earned prior to bankruptcy, although the taxes are not payable until the wages are paid.

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[16] U.S. Code Congressional and Administrative News, 1966, p. 2468. *In re Kopf*, 299 F. Supp. 182 (E.D.N.Y. 1969).

The Third Circuit in dealing with this issue first noted that, "It is well settled that the term 'legally due and owing' does not mean 'payable'" (at p. 104). It then resolved the tax uncertainty question by ruling that by reference to the annual wage of each employee, as disclosed by the bankrupt's records, a maximum tax figure is available for the purposes of provability under Section 64(a)(4).

This court also concurs with the Third Circuit that there has been a concerted legislative effort to reduce the significance of tax claims relative to other priorities under the Bankruptcy Act which justifies a fourth priority here. This view of the legislative trend was recently reaffirmed by the Supreme Court in *United States* v. *Randall, supra.* In the *Randall* case the bankrupt corporation was allowed to continue in business as debtor in possession. The order thus appointing the corporation required it to open three separate bank accounts for its general, payroll, and tax indebtedness and to make appropriate disbursements from those accounts. Withheld taxes were to be paid into the tax indebtedness account, but the debtor in possession failed to comply with the court's order. Income taxes from wage payments had been withheld by the corporation, but they had not been deposited in the special tax account or paid to the Government. When the corporation was later adjudicated a bankrupt, the Government, which had previously filed a proof of claim in the Chapter XI proceeding for the payment of these taxes, moved in the bankruptcy court for an order allowing payment of these withheld taxes prior to payment of the costs and expenses of administration of the bankruptcy proceeding. The Government's theory was that the withheld taxes constituted a trust in favor of the United States. The referee denied the Government's claim. This denial was affirmed by the District Court and the Court of Appeals for the Seventh Circuit. The United States Supreme Court granted certiorari because of a conflict among the circuits. In affirming the lower court's decision

in *Randall* the Court ruled that the Bankruptcy Act is an overriding statement of federal policy on the question of priorities. It then quoted from that part of Section 64(a)(1) of the Act which gives priority to the costs and expenses of administration of a superseding bankruptcy over the costs and expenses of administration of the superseded Chapter XI proceeding. The Court there pointed out that until 1926 taxes were placed ahead of costs and expenses of administration. However, in that year Section 64 was amended to place costs and expenses in the first priority and taxes legally due and owing from the bankrupt in the fourth priority. And in 1952 the Section was again amended to give priority to administrative costs and expenses of a superseding bankruptcy over costs and expenses of a Chapter XI proceeding. The Court said: "We have then a progressive legislative development that (1) marks a decline in the grant of a tax preference to the United States and (2) marks an ascending priority for costs and expenses of administration."

Here the Government has filed a proof of claim for the taxes due on those wages actually paid in the three month period preceding bankruptcy (Claim 441). It admits that these taxes are entitled to only a fourth priority as taxes which became legally due and owing by the bankrupt before bankruptcy. If the taxes due on the wages actually paid are entitled to only a fourth priority, why should the taxes on wages earned but simply not paid during that period be entitled to a higher priority? To assign a first priority to the later group of taxes would make those taxes payable ahead of the wages, themselves, which are entitled to only a second priority.

The fourth question is whether the Government's claim here is barred by failure to file a proof of claim. The Third Circuit said: "The mere fact of payment after the filing does not, for bankruptcy purposes, lessen the ability of the Government to file a proof of claim. Because a maximum

figure is ascertainable, though subject to reduction, an adequate proof of claim can be filed" (at p. 106). The Third Circuit thereupon barred the Government's claim on the ground that it had failed to file a proof of claim, in apparent reliance upon the *Fogarty* case. This court agrees with the Third Circuit that the amount of the taxes due here are readily ascertainable but by a different method. It disagrees with the Third Circuit that the Government's claim is barred by its failure to file a proof of claim. With all due respect, this court finds that holding by the Third Circuit incongruous.

Here the total of the unpaid wages were scheduled by the bankrupt. The Chapter XI petition filed herein on September 15, 1964 reads: "There are approximately $80,000 in wages due employees as set forth in the debtor's payroll records for the four-month period immediately preceding the filing" (Schedule A-1). Thereafter, and within the six months allowed for the filing of such claims (11 U.S.C. § 93), 413 wage claims were filed against the $80,000 figure. These 413 claims have been checked by the trustee (in some instances they were contested) and approved by the referee for payment. The referee's order approving payment of these claims without withholding therefrom employee social security and income taxes is the order now before this court for review. When the wage claimants filed their proofs of claim, each such claim was for the full amount due that employee. It was not a claim for the full amount less the taxes due thereon. The trustee and the referee thus had before them a claim in each instance which included the Government's claim. By the simple expedient of applying the long standing 25% rule to each claim, the amount of the taxes due is readily ascertainable. If the amount of wages due each employee is known and can therefore be made the basis of a proof of claim, it is difficult to see why

the income and social security taxes due thereon are not proved by the same piece of paper.[17]

The purpose of requiring a proof of claim before any payment can be made from the estate of a bankrupt is obvious. 11 U.S.C. § 93. The estate must be protected against incorrect or fraudulent claims. When an employee files his proof of claim for the total of his pre-bankruptcy wages, the requirement of proof of claim before the Government can be paid its taxes has plainly been met. To require the Government to file another proof of claim with respect to those same wages does not appear to have been mandated by the Congress. The Government is entitled to taxes only on those wage claims actually filed, proved and paid. This is why there is uncertainty about the amount of taxes due. It is not an uncertainty arising from an inability to compute or know the tax on the day the bankruptcy petition is filed. It is an uncertainty arising from an inability to know who will file a proof of claim. Once a proof of claim is filed by a wage earner, all uncertainty ends. And the requirement that the Government file another proof of claim is simply a hypertechnical construction of the proof of claim requirement. In the case of taxes due on wages *actually paid* in the pre-bankruptcy period, the Government obviously must file a proof of claim since no proofs of claim would be filed by the wage earners involved. Here, however, the situation is different. Proof of claim must be filed by each wage earner before the Government can recover its taxes. This court therefore holds that a second proof of claim by the Government is not required.

The final question is whether New York City is entitled to have a 1% income tax withheld from each wage distribution for its benefit. New York City did not enact any income tax law until 1966. Manifestly there were no taxes

[17] 40 N.Y.U. Law Rev. 360, 364 (1965).

that could be said to be legally due and owing to the City of New York by the bankrupt in any sense in September 1964 when the Chapter XI proceeding was filed. Since the bankrupt owed no "knowable" or computable tax to the City in 1964, the City has no claim enforceable in bankruptcy. *Matter of International Match Corp., supra.*

For the reasons set forth above, the decision and order of the referee are reversed and the trustee should be directed by the referee to: 1) withhold each employee's federal income and social security tax contribution from each wage claim distribution; 2) furnish each employee with the required W-2 form; 3) file the required form 941 and W-3; and 4) pay the withheld taxes to the United States.

Submit order on five days notice.

Dated: New York, New York
February 29, 1972

CONSTANCE BAKER MOTLEY
U.S.D.J.

Order in Bankruptcy

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

No. 64-B-727

In the Matter

—of—

FREEDOMLAND, INC.,

Bankrupt.

Upon the proceedings before this Court on January 20 and 21, 1972, and upon the proofs of claim filed in this estate and the record below and this Court having rendered its decision, which was filed February 29, 1972, it is hereby

ORDERED, that the petition by the City of New York to review the referee's order of February 26, 1971, is denied, and it is further

ORDERED, that the petition by the United States to review the referee's order of February 26, 1971, be and it hereby is granted, and the said order is reversed insofar as it pertains to federal taxes, and accordingly the referee is directed to order the trustee 1) to withhold from distributions to wage claimants a sum equal to twenty-five percent of each distribution, for each employee's federal income and Social Security tax contribution; 2) to furnish each employee with the appropriate W-2 form; 3) to file Forms 941 and W-3 with the Internal Revenue Service; and 4) to pay the withheld taxes to the United States, when Section 64 (a)(4) payments are allowed.

Dated: New York, New York
March 22, 1972

/s/ CONSTANCE BAKER MOTLEY
U.S.D.J.

Statutes Involved

Title 11, United States Code:

§ 67. Duties of Referees

a. Referees shall * * * (5) declare dividends and cause to be prepared dividend sheets showing the dividends declared and to whom payable;

§ 75. Duties of Trustees

a. Trustees shall * * *; (11) pay dividends within ten days after they are declared by the referees;

§ 93. Proof and allowance of Claims

a. A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim; the consideration therefor; whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor. * * *

j. Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

n. Except as otherwise provided in this title, all claims provable under this title, including all claims of the United States and of any State or any subdivision thereof, shall be proved and filed in the manner provided in this section. Claims which are not filed within six months after the first date set for the first meeting of creditors shall not be allowed.

§ 103. Debts which may be proved

(a) Debts of the bankrupt may be proved and allowed against his estate which are founded upon * * * (8) contingent debts and contingent contractual liabilities;

§ 104. Debts which have priority

(a) The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be (1) the costs and expenses of administration, including the actual and necessary costs and expenses of preserving the estate subsequent to filing the petition; the fees for the referees' salary and expense fund; the filing fees paid by creditors in involuntary cases or by persons other than the bankrupt's in voluntary cases; where property of the bankrupt, transferred or concealed by him either before or after the filing of the petition, is recovered for the benefit of the estate of the bankrupt by the efforts and at the cost and expense of one or more creditors, the reasonable costs and expenses of such recovery; the trustee's expenses in opposing the bankrupt's discharge or in connection with the criminal prosecution of an offense punishable under chapter 9 of Title 18, or an offense concerning the business or property of the bankrupt punishable under other laws, Federal or State; the fees and mileage payable to witnesses as now or hereafter provided by the laws of the United States, and one reasonable attorney's fee, for the professional services actually rendered, irrespective of the number of attorneys employed, to the bankrupt in voluntary and involuntary cases, and to the petitioning creditors in involuntary cases, and if the court adjudges the debtor bankrupt over the debtor's objection or pursuant to a voluntary petition filed by the debtor during the pendency of an involuntary proceeding, for the reasonable costs and expenses incurred, or the reasonable disbursements made, by them, including but not limited to compensation of accountants and appraisers employed by them, in such amount as

the court may allow. Where an order is entered in a proceeding under any chapter of this title directing that bankruptcy be proceeded with, the costs and expenses of administration incurred in the ensuing bankruptcy proceeding, including expenses necessarily incurred by a debtor in possession, receiver, or trustee in preparing the schedule and statement required to be filed by section 638, 778, or 883 of this title, shall have priority in advance of payment of the unpaid costs and expenses of administration, including the allowances provided for in such chapter, incurred in the superseded proceeding and in the suspended bankruptcy proceeding, if any; (2) wages and commissions, not to exceed $600 to each claimant, which have been earned within three months before the date of the commencement of the proceeding, due to workmen, servants, clerks, or traveling, or city salesmen on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; and for the purposes of this clause, the term "traveling or city salesman" shall include all such salesmen, whether or not they are independent contractors selling the products or services of the bankrupt on a commission basis, with or without a drawing account or formal contract; (3) where the confirmation of an arrangement or wage earner plan or the bankrupt's discharge has been refused, revoked, or set aside upon the objection and through the efforts and at the cost and expense of one or more creditors, or, where through the efforts and at the cost and expense of one or more creditors, evidence shall have been adduced resulting in the conviction of any person of an offense under chapter 9 of Title 18, the reasonable costs and expenses of such creditors in obtaining such refusal, revocation, or setting aside, or in adducing such evidence; (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,*

That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court; and (5) debts other than for taxes owing to any person, including the United States, who by the laws of the United States is entitled to priority, and rent owing to a landlord who is entitled to priority by applicable State law or who is entitled to priority by paragraph (2) of subdivision c of section 107 of this title: *Provided, however,* That such priority for rent to a landlord shall be restricted to the rent which is legally due and owing for the actual use and occupancy of the premises affected, and which accrued within three months before the date of bankruptcy.

Title 26, United States Code:

§ 3102. Deduction of tax from wages

(a) Requirement.—The tax imposed by section 3101 shall be collected by the employer of the taxpayer, by deducting the amount of the tax from the wages as and when paid. An employer who in any calendar quarter pays to an employee cash remuneration to which paragraph (7)(B) or (C) or (10) of section 3121(a) is applicable may deduct an amount equivalent to such tax from any such payment of remuneration, even though at the time of payment the total amount of such remuneration paid to the employee by the employer in the calendar quarter is less than $50:

§ 3401. Definitions

(a) Wages.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

* * * * *

(d) Employer.—For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

§ 3402. Income tax collected at source

(a) Requirement of withholding.—Every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables. For purposes of applying such tables, the term "the amount of wages" means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table in subsection (b)(1):

§ 6001. Notice or regulations requiring records, statements, and special returns

Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary or his delegate may from time to time prescribe. Whenever in the judgment of the Secretary or his delegate it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary or his delegate deems sufficient to show whether or not such person is liable for tax under this title.

§ 6011. General requirement of return, statement, or list

(a) General rule.—When required by regulations prescribed by the Secretary or his delegate any person made liable for any tax imposed by this title, or for the collection thereof, shall make a return or statement according to the forms and regulations prescribed by the Secretary or his delegate. Every person required to make a return or statement shall include therein the information required by such forms or regulations.

§ 6041. Information at source

(a) Payments of $600 or more.—All persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments to which section 6042(a) (1), 6044(a) (1), or 6049(a) (1) applies, and other than payments with respect to which a statement is required under the authority of section 6042(a) (2), 6044(a) (2), 6045, 6049(a) (2), or 6049 (a) (3)), of $600 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Secretary or his delegate, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary or his delegate, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

§ 6672. Failure to collect and pay over tax, or attempt to evade or defeat tax

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully

fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalities provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable. Aug. 16, 1954, 736, 68A Stat. 828.

Order Allowing Certiorari

SUPREME COURT OF THE UNITED STATES

No. 73-375

WILLIAM OTTE, Trustee in Bankruptcy of FREEDOMLAND, INC.,

Petitioner,

—v.—

UNITED STATES and THE CITY OF NEW YORK,

Appellants.

ORDER ALLOWING CERTIORARI. Filed January 21, 1974.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted.